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# *Federal Reserve Operations*

## *Consumer and Community Affairs*

In 2000 the Board continued its work in several key areas of consumer and community affairs—preparing and interpreting consumer banking-related issues; providing information to audiences that include consumers, community groups, financial institutions, and small businesses; and supervising state member banks for compliance with the federal consumer banking and civil rights laws. In conjunction with these activities, the Board worked to implement various provisions of the Gramm–Leach–Bliley (GLB) Act.

Regulatory efforts to implement the GLB Act included issuing two new regulations and revising one. The new rules, Regulations P and G, deal respectively with the privacy of consumers' financial information and the reporting and disclosing of certain agreements under the legislation's Community Reinvestment Act (CRA) "sunshine" provision. Revisions to Regulation H target the adoption of consumer protection rules for the retail sale of insurance and annuities by state member banks. Non-regulatory efforts to implement the GLB Act included the extension of the CRA examination frequency for small banks.

The Board also engaged in significant efforts in other areas. One of these efforts was related to the predatory lending hearings the Board held in several cities around the country (see box). Another was a System initiative to help revitalize an important business corridor in the District of Columbia (see box).

Additionally, to promote consumer financial education, the Board created a computer-based program on vehicle leasing that may be downloaded from the Board's Internet web site

([www.federalreserve.gov/pubs/leasing](http://www.federalreserve.gov/pubs/leasing)). The program provides consumers with a basic understanding of how leasing works and a means for calculating how lease terms affect the cost of the monthly lease payment.

### **Regulatory Matters**

The Board has responsibility for implementing federal laws concerning consumer financial services and fair lending. In addition to rulemakings involving Regulations C (Home Mortgage Disclosure) and Z (Truth in Lending), the Board issued new regulations implementing provisions of the GLB Act, in cooperation with other federal regulatory agencies.

In June the Board published Regulation P, which governs the privacy of consumer financial information under title V of the GLB Act.<sup>1</sup> Regulation P requires a financial institution to provide notice to customers about its privacy policies and practices and describes the conditions under which a financial institution may disclose nonpublic personal information about consumers to non-affiliated third parties. Also, under the regulation, consumers may direct a financial institution not to disclose that information to most nonaffiliated third parties by "opting out," subject to certain exceptions.

In September the Board published revisions to Regulation Z to revise the

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1. The other federal bank and thrift regulatory agencies—together with the Securities and Exchange Commission, the National Credit Union Administration, and the Federal Trade Commission—issued comparable rules.

## **Abusive Practices in Home Equity Lending**

Abusive practices in home equity lending received significant attention from the Board and other regulatory agencies during the year. Information about abusive lending practices is essentially anecdotal, but the frequency of reports from a wide range of sources clearly suggests that a problem exists. The reports indicate that abusive practices are frequently targeted at elderly, female, or minority borrowers and can result in the consumer's losing much of the equity in the home or even the home itself.

"Predatory lending" consists of a variety of practices that typically involve at least one of the following abuses: (1) making loans based on the borrower's equity in the home rather than on the borrower's ability to repay the debt, (2) inducing a borrower to refinance a loan repeatedly, charging high fees each time, and (3) using fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

To address abusive practices in high-cost home equity loans, the Congress in 1994 enacted the Home Ownership and Equity Protection Act (HOEPA) as part of the Truth in Lending Act. HOEPA requires additional disclosures for home equity loans bearing rates or fees above a certain percentage or amount and also imposes limitations on certain terms (for example, restricting short-term balloon notes and

prepayment penalties). HOEPA also prohibits creditors from engaging in a pattern or practice of making high-cost loans without regard to the borrower's ability to make the scheduled payments.

The volume of home equity lending has increased significantly in the past few years. Much of this increased lending can be ascribed to the rapid growth of the subprime mortgage market, which provides access to credit to consumers who do not meet underwriting criteria for "prime" loans. Based on data reported under the Home Mortgage Disclosure Act, the number of loans made by lenders that specialize in subprime loans increased about six-fold between 1994 and 1999—from 138,000 to roughly 856,000. The greater availability of credit to subprime borrowers is a positive development, but continuing reports of abusive practices raise concerns that there has been a corresponding increase in predatory loans.

During the summer of 2000, the Board held public hearings in Charlotte, Boston, Chicago, and San Francisco to consider how it might use its regulatory authority to deter predatory practices in home equity lending. The hearings focused on expanding the scope of mortgage loans covered by HOEPA, prohibiting specific acts and practices that lead to abuses, improving consumer disclosures, and educating consum-

disclosure requirements for credit and charge cards. Under the Fair Credit and Charge Card Disclosure Act of 1988, direct mail and other solicitations and applications to open card accounts must disclose the annual percentage rate (APR) and other cost information, generally in the form of a table. Under the Board's revised rules, the APR for purchases must be in at least 18-point

type and must appear under a separate heading from other APRs that may apply, such as penalty rates. Disclosures must be in a reasonably understandable form readily noticeable to consumers, and they must include the APRs for cash advances and balance transfers as well as balance transfer fees.

In November the Board revised Regulation H to adopt consumer protec-

ers. The Board received testimony from invited panelists and comments from members of the public.

During the hearings and in the comment letters, most creditors and others involved in mortgage lending generally opposed expanding the scope of mortgage loans covered by HOEPA. They expressed concern about the potential for reducing the availability of credit in the subprime market if more loans become subject to HOEPA and to additional restrictions.

On the other hand, consumer representatives and community development organizations, supported a broadening of HOEPA's scope. These commenters recommended that the Board ban certain acts or practices associated with predatory loans, such as prepayment penalties and balloon payments, single premium credit insurance, and "loan flipping."

On December 26, 2000, the Board published proposed amendments to its Regulation Z to address high-cost loans. The amendments would (1) adjust the price triggers used to determine HOEPA coverage and thereby expand the number of mortgage loans subject to HOEPA, (2) prohibit certain acts and practices in home-secured loans—for example, creditors could not engage in repeated refinancings of their own HOEPA loans over a short time period unless the transactions are in the borrower's interest, (3) generally require creditors to document and verify a consumer's income for HOEPA-covered

loans to strengthen HOEPA's prohibition against loans made without regard to the consumer's ability to repay, and (4) enhance disclosures provided to consumers before closing certain HOEPA-covered loans.

Other initiatives are under way to address predatory lending:

- Bills have been introduced in the Congress, and several states have enacted or are considering legislation or regulations
- A federal task force of ten federal agencies and offices is working to establish a coordinated approach to deter abusive and predatory practices and to enforce existing laws that address such practices
- HUD and Treasury held five public forums on predatory lending and issued a report in June 2000. The report contained recommendations to the Congress for legislative action and to the Board for using its regulatory authority
- Fannie Mae and Freddie Mac developed guidelines to avoid purchasing predatory loans and are working to develop consumers' awareness of their credit options
- The Board is considering other strategies to address predatory lending concerns, such as community outreach and consumer education. The Federal Reserve has worked actively with financial institutions, consumer and community organizations, and other federal agencies to discuss issues and identify possible steps for mitigation of the problems.

tion rules for the retail sale of insurance and annuities by state member banks, thereby implementing section 305 of the GLB Act. The rules require depository institutions (and any person selling or offering insurance products or annuities to consumers at an office of, or on behalf of, a depository institution), to make certain disclosures before completing a sale. The disclosures inform consumers

that the insurance or annuity is not a deposit or obligation of the depository institution and is not FDIC insured and that the depository institution may not condition an extension of credit on the consumer's purchase of insurance or an annuity from the financial institution or any of its affiliates. The disclosure must also note any investment risk associated with the insurance product or annuity.

## The Upper Georgia Avenue Corridor: Economic Gateway to the District

*Let's not lose sight of the myriad of important activities of the vast majority of small businesses, especially in neighborhoods such as this [Georgia Avenue], where they provide vital services to help the community prosper and grow.*

Alan Greenspan, *Chairman*, Board of Governors  
at the Georgia Avenue Business Resource Center Grand Opening  
August 10, 2000

Expanding the private sector ranks high among ways to stimulate economic growth in the District of Columbia. District officials recognize the importance of the private sector not only in the downtown centers but also in neighborhoods with small, community-based businesses that add stability to the local economy. Accordingly, the process of developing small businesses has brought new dimensions and new participants to revitalization efforts in District communities.

Meetings hosted in 1999 by the Federal Reserve laid the groundwork for a variety of public-private partnerships, the type of cooperative effort that is vital to attracting investment and development in target neighborhoods like the Georgia Avenue corridor. By the fall of 2000, collaboration among stakeholders produced the Georgia Avenue Business Resource Center; created technical-assistance partnerships with the District of Columbia, the U.S. Small Business Administration (SBA), and area universities including the masters in business administration (MBA) programs of George Washington University, the University of the District of Columbia, Howard University, and Southeastern University; and established lending relationships with Riggs Bank, City First Bank (a certified Community Development Financial Institution), and other local lenders.

### Why Georgia Avenue?

The upper Georgia Avenue commercial corridor, in the Northwest quadrant of Washington, D.C., is one of the city's busi-

est north-south thoroughfares and a major link between the District of Columbia and Maryland. District and Maryland establishments with strong historical and employment ties to the region border the corridor; they include the Walter Reed Army Medical Center, a suburban Maryland central business district, sixty small businesses, and colleges and universities.

Over time, however, cross-border business issues, physical blight, and safety concerns had diminished the corridor's redevelopment potential. Not even the combination of favorable regional access, high transit volume, and a strong homeownership base could reverse or even stay the economic downturn of Georgia Avenue.

District officials studied the area's redevelopment needs and recommended that partnerships across jurisdictions, including cooperative agreements with area lenders, businesses, universities, and neighborhoods in Maryland and the District, were the key to successfully restoring upper Georgia Avenue's status as the gateway to the District.

### A Meeting of the Minds

In 1999 the Federal Reserve System began participating in the District's planning for overall business development—before the planning focused specifically on Georgia Avenue—and brought other major stakeholders into the process.

Alice M. Rivlin, then Vice Chair of the Federal Reserve Board, and J. Alfred Broadus, Jr., President of the Federal

Reserve Bank of Richmond, convened a meeting in June 1999 to encourage private-sector participation in the District's business development process. Among the participants were the chief executive officers and senior officials of local governmental, academic, community, and private-sector organizations integral to community development. At that meeting, Federal Reserve officials secured commitments from CEOs to take an active role in helping the District meet its business development and financing needs.

The CEOs and other supporters next attended a business forum hosted by the Federal Reserve in July 1999. The forum highlighted nationwide best practices and approaches to inner-city commercial redevelopment that could be adapted for use in the District, including the Access to Capital project in Cleveland. The Access to Capital project, facilitated by the Federal Reserve Bank of Cleveland, was undertaken to improve the success rate of the city's new and growing businesses by matching resource providers to business needs.

In the fall, Richmond Reserve Bank president Broaddus and Federal Reserve Board Member Edward Gramlich, who chairs the Federal Reserve Board's Oversight Committee on Consumer and Community Affairs, met with District leaders to discuss a project based on the Cleveland model. At this meeting, District officials and their partners decided to focus initial recovery efforts on Georgia Avenue, and all agreed to start with the small businesses that once contributed significantly to the economic health of the community.

The discussions were the catalyst that brought to life the small-business features of the District's economic resurgence plan. The resulting public-private partnerships helped the District identify ways to make capital available to community-based and emerging businesses in general and along the Georgia Avenue corridor in particular.

### **Let the Record Show**

The business, government, and community linkages led relatively quickly to significant activity along the upper Georgia Avenue corridor. The Georgia Avenue Business Resource Center was launched in 2000, with Federal Reserve Board Chairman Alan Greenspan joining local officials at the opening ceremonies on August 10.

The resource center will be the first District satellite office of the U.S. Small Business Administration's One-Stop Capital Shop. Developed through a joint venture between the SBA and the District of Columbia, the One-Stop Capital Shop helps small businesses in the District obtain financial and technical assistance. The District contributed initial funding for the center's staff jointly with the District of Columbia Chamber of Commerce.

Volunteers and SBA representatives visit the center weekly to discuss SBA loan guarantee programs and support services for small businesses. Loan officers from local banks conduct seminars on financial services and meet with clients on bank products and programs. Clients that are initially unbankable receive assistance in business planning, marketing, grant writing, and other business development areas from MBA students at area universities.

By winter 2001 the DC Chamber of Commerce plans to launch a mentorship program that will match new, growing, or troubled businesses with established business members of the Chamber for ongoing technical assistance. The Georgia Avenue Business Resource Center also plans to partner with the Foundation for International Community Assistance, another Community Development Financial Institution, to provide micro-loan support and credit counseling.

The Upper Georgia Avenue project illustrates the extent to which local revitalization initiatives can benefit from efforts to mobilize all elements of the community.

In December the Board published Regulation G to implement the sunshine requirements; comparable rules were issued by the other federal bank and thrift regulatory agencies. The GLB Act established annual reporting and public disclosure requirements for certain written agreements that are made in connection with the CRA and that are entered into between insured depository institutions or their affiliates and nongovernmental entities or persons. Among other things, the regulation identifies the types of covered agreements and describes how the parties to those agreements will make them available to the public and the appropriate agencies.

In addition the Board took the following regulatory and interpretive actions during the year:

- Revised the official staff commentary to Regulation Z to clarify that short-term cash advances commonly called “payday loans” are credit transactions covered by the regulation
- Adjusted the dollar amount of points and fees that triggers additional requirements for certain mortgage loans under the Home Ownership and Equity Protection Act of 1994 (HOEPA)
- Increased to \$31 million the exemption threshold for depository institutions required to collect data in the year 2001 under the Home Mortgage Disclosure Act.

The Board also proposed amendments to Regulation C and to the HOEPA provisions of Regulation Z. The Regulation C proposal includes the following elements:

- Requiring lenders to report requests for preapprovals that meet certain conditions

- Requiring lenders to report home equity lines of credit
- Expanding coverage of nondepository lenders
- Requiring lenders to report additional data about loans and applications (such as the annual percentage rate and whether the application involves a manufactured home).

The proposed amendments to HOEPA include the following elements:

- Extending coverage to more loans in two ways: by lowering the APR threshold and by expanding the closing cost trigger
- Addressing “flipping” (frequent refinancings) by prohibiting certain refinancings unless the transaction is in the borrower’s interest
- Strengthening the rules regarding verification of a consumer’s ability to repay a loan.

### **Consumer Advisory Council**

The Board’s Consumer Advisory Council convened in March, June, and October 2000 to advise the Board on matters concerning laws related to consumer financial services. The council’s members come from consumer and community organizations, the financial services industry, academic institutions, and state agencies. Council meetings are open to the public.

The CRA sunshine provisions of the GLB Act was a major topic at all three meetings. In March and June, council members discussed the language in the statute concerning what CRA agreements should be covered and how they should be reported to the federal banking agencies. Some members suggested that a CRA agreement should exist only when contacts had been made with executive management within a finan-

cial institution. In October members discussed actions regulators could take to clarify requirements in the proposed regulation.

The Board's proposed privacy regulation, Regulation P, was discussed at the March meeting. Council members commented on methods for handling opt-out notices, situations permitting financial institutions to share customer information with nonaffiliated third parties, and alternatives for defining "publicly available information." Members noted the complexity involved in preparing rules that cover a broad range of financial services and products.

Disclosure requirements for credit and charge card solicitations and applications were a key topic at the March and June meetings. Council members provided views on whether the cost disclosures in the required table were clear and conspicuous and whether the table was in a prominent location. In June, council members discussed the proposed amendments to Regulation Z, aimed at providing consumers with more noticeable and easier-to-understand cost information.

Predatory lending—and in particular, how the Board might use its rulewriting authority under HOEPA to help deter abusive practices in home equity lending—was addressed at the June and October meetings. In June, council members identified issues for the Board to raise in public hearings that were to be held that summer. At the October meeting, members discussed changes to Regulation Z to implement the HOEPA rules. These changes focused primarily on addressing concerns about loan flipping, foreclosure notices, and the points and fee triggers that define HOEPA loans.

In October the council discussed Regulation C, which implements the Home Mortgage Disclosure Act

(HMDA). The members discussed possible changes to the regulation intended to improve the usefulness of the data that mortgage lenders are required to disclose. Members expressed differing views on potential changes, such as modifying the definition of "refinancing," adding the collection of loan pricing information, and expanding coverage of nondepository lenders. Despite opposing viewpoints and recognition of some data limitations, members generally viewed the HMDA data as a valuable tool for both regulators and the public.

## **Applications**

During 2000 the Board of Governors considered applications for several significant banking mergers.

- In May the Board approved an application by the Charles Schwab Corporation, San Francisco, to become a bank holding company by acquiring U.S. Trust Corporation, New York. The simultaneous declaration by Charles Schwab to become a financial holding company was the first application by a brokerage firm to acquire a banking company since the enactment of the GLB Act.
- In September the Board approved related applications by North Fork Bancorporation, Melville, New York, to acquire Dime Bancorp, Inc., New York, and by FleetBoston Financial Corporation, Boston, to acquire up to 9 percent of the voting shares of North Fork.
- In October the Board approved an application by Wells Fargo & Company, San Francisco, the seventh largest commercial banking organization in the United States, to acquire First Security Corporation, Salt Lake



City, the thirty-ninth largest banking organization.

Comments received on these applications raised a variety of concerns ranging from allegations of predatory lending to the inadequacy of banking credit and services provided in low- and moderate-income communities. In each of these applications, the Board found that the CRA records of the depository institutions involved were consistent with approval.

In addition, the Board in 2000 acted on twelve bank and bank holding company applications that involved protests by members of the public concerning the performance under the CRA of insured depository institutions. The Board also reviewed two applications that involved institutions having less than satisfactory CRA ratings and another thirty-seven applications involving other issues related to CRA, fair lending, or compliance with consumer credit protection laws.<sup>2</sup>

## **Fair Lending**

Under the Equal Credit Opportunity Act, the Board refers to the Department of Justice all violations that it has reason to believe constitute a “pattern or practice” of discrimination. The Board referred two cases in 2000. One involved a policy and practice of unlawfully requiring the signatures of the spouses of loan applicants on debt instruments; the other involved a practice of discriminatory loan pricing on the prohibited basis of age.

During 2000 the Board continued to prepare examiners to conduct fair lending examinations by offering regular

sessions of a comprehensive two-week training course. In addition, the Board developed two specialized courses. The first of these is a week-long program that provides community affairs staff members, who are not examiners, with an overview of fair lending concepts. The second is a one-week course for fair lending examiners that concentrates on commercial lending concepts and practices.

The Federal Reserve uses a two-stage statistical regression analysis to help assess fair lending compliance by large-volume mortgage lenders. In the first stage, the program analyzes HMDA data to identify banks with loan denial rates for racial and ethnic minority applicants that are significantly different from those for nonminority applicants.<sup>3</sup> In the second stage, the program is applied to extensive additional information taken from a sample of the loan files of the banks identified in the first stage.

In 2000 the Board again hosted a Systemwide conference to enable Reserve Bank users of the regression analysis program to discuss their accumulated experiences with Board staff members. Those discussions resulted in proposals to add gender-based analysis capabilities and to permit racial discrimination analyses even when the number of denied applicants is quite small.

## **HMDA Data and Mortgage Lending Patterns**

The Home Mortgage Disclosure Act requires mortgage lenders covered by the act to collect and make public certain data about their home purchase, home improvement, and refinancing loan transactions. Depository institu-

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2. In addition, two applications involving adverse CRA ratings and two involving other CRA or compliance issues were withdrawn in 2000.

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3. See the next section for a discussion of the collection of HMDA data.

tions generally are covered if they were located in metropolitan areas and met the asset threshold at the end of the preceding year. For 1999, the asset threshold for depository institutions was \$29 million. Mortgage companies are covered if, at the end of the preceding year, they were located in or made loans in metropolitan areas and had assets of more than \$10 million (when combined with the assets of any parent company). They are also covered, regardless of asset size, if they originated 100 or more home purchase loans in the preceding year.

In 2000 a total of 6,730 depository institutions and affiliated mortgage companies and 1,103 independent mortgage companies reported HMDA data for calendar year 1999 to their supervisory agencies. These lenders submitted information about the geographic location of the properties related to their loans and applications, the disposition of loan applications, and, in most cases, the race or national origin, income, and sex of applicants and borrowers.

The Federal Financial Institutions Examination Council (FFIEC) processed the data and produced disclosure statements on behalf of the Department of Housing and Urban Development (HUD) and the FFIEC's member agencies.<sup>4</sup> The FFIEC prepared individual disclosure statements for each lender that reported data—one statement for each metropolitan area in which the lender had offices and reported loan activity. For 1999 data, the FFIEC prepared 56,966 disclosure statements.

In July 2000 each institution made its disclosure statement public; and reports

containing aggregate data for all lenders in a given metropolitan area were made available at central depositories in the nation's approximately 330 metropolitan areas. These data are used by HUD and the Department of Justice as one component of their fair lending reviews, by the FFIEC's member agencies, the reporting institutions, and the public; HUD also uses the data in its oversight of Fannie Mae and Freddie Mac. In addition, the data assist HUD, the Department of Justice, and state and local agencies in responding to allegations of lending discrimination and in targeting lenders for further inquiry.<sup>5</sup>

The 1999 data that were reported in 2000 covered 22.9 million loans and applications, a decrease of about 7 percent from 1998 data. The decrease was due primarily to a decline of about 18 percent in refinancing activity. When compared with 1998, the number of home purchase loans extended in 1999 increased 44 percent for Native American applicants, 18 percent for Hispanic, 16 percent for Asian, 11 percent for black, and 2 percent for white applicants. Over the seven years from 1993 through 1999, the number of home purchase loans extended increased 121 percent for Hispanics, 119 percent for Native Americans, 91 percent for blacks, 70 percent for Asians, and 34 percent for whites.

The number of home purchase loans extended to applicants in all income categories increased in 1999 compared with the preceding year. The number of such loans extended to lower-income applicants increased 14 percent, while

4. The member agencies of the FFIEC are the Board, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

5. On behalf of the nation's seven active private mortgage insurance (PMI) companies, the FFIEC also compiles information on applications for PMI similar to the information on home mortgage lending collected under HMDA. Lenders typically require PMI for conventional mortgages that involve small down payments.

the number extended to upper-income applicants increased 4 percent. Over the seven years from 1993 to 1999, the number of home purchase loans extended to lower-income applicants increased 86 percent, and the number extended to upper-income applicants increased 51 percent.

In 1999, 31 percent of Hispanic and 24 percent of black applicants for home purchase loans sought government-backed mortgages; the comparable figures for white, Native American, and Asian applicants were 14 percent, 12 percent, and 10 percent respectively. Twenty-four percent of lower-income applicants for home purchase loans applied for government-backed loans in 1999, compared with 10 percent of upper-income applicants.

Overall, the denial rate for conventional home purchase loans was 28 percent in 1999. The denial rate had been increasing over the past several years but fell slightly (about 1 percentage point) from 1998 to 1999. In 1999, denial rates for conventional home purchase loans (those not backed by a government guarantee of repayment) were 49.0 percent for black, 42.1 percent for Native American, 35.0 percent for Hispanic applicants, 25.5 percent for white, and 11.8 percent for Asian applicants. Except for Asian applicants, each of these rates was lower, by a small margin, than the comparable rate for 1998.

### **Consumer Policies**

Through its consumer policies program, the Board conducts research and explores ways to protect consumers, other than by regulation, in the area of retail financial services. In 2000 the Board worked with other agencies and with public- and private-sector organizations to develop education materials

designed to increase consumers' financial literacy. Work is progressing on education resources to help consumers avoid abusive lending practices.

One significant education effort involved the development of a computer program on vehicle leasing that the public can download from the Board's Internet web site. This program answers three key questions:

- How is leasing different from buying?
- What are the upfront, ongoing, and end of lease costs?
- How do you compare lease offers and negotiate lease terms?

Included in the program are a checklist to use when shopping for a lease, information on how to read lease ads, sample leasing disclosure forms, and a calculator that can be used to show how changing a term in the lease agreement changes the cost of the monthly payment.

During 2000 the Board released the thirteenth edition of the *Consumer Handbook to Credit Protection Laws*. This publication provides consumers with information on the Truth in Lending Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act, the Consumer Leasing Act, and the Electronic Fund Transfer Act.

The Board hosted a forum on "Best Practices in Consumer Credit Education," with participation from a wide range of public- and private-sector consumer educators. The goals of the forum were to develop a list of best practices, focusing on effective tools and techniques, and to identify strategies to foster effective credit education.

The Board's consumer policies program received an award from the College for Financial Planning for research

on how consumers search for information in mortgage shopping, as well as national recognition for research on banking relationships of underserved consumers. Electronic banking continued to be a topic for research by staff members, who use data from the University of Michigan Survey Research Center and from consumer focus groups.

### **Community Affairs**

The Federal Reserve's Community Affairs Offices sponsor activities that communicate the availability of resources and strategies for community economic development. The twelve Reserve Banks target the information and development needs of their Districts. The Board's Community Affairs Office offers a national perspective, engaging in projects that have broad implications for public policy or that promote issues that are industrywide in scope. Through these programs, the Federal Reserve during 2000 provided technical assistance, conducted nearly 1,600 outreach meetings, sponsored 288 conferences and workshops, and distributed about 2000,000 publications related to community development.

In 2000 the System's community affairs function began planning—in collaboration with research colleagues at the Board and the Reserve Banks—a research conference for early 2001 devoted to the effect of changing financial markets on the delivery of financial services to low-income populations and communities. The agenda for the symposium, entitled "Changing Financial Markets and Community Development," will feature research that resulted from a call for papers. It will focus on the Community Reinvestment Act, predatory lending, credit scoring, wealth creation, and alternative financial services.

In 2000 the Board published a directory of the community development corporations owned by bank holding companies and state member banks throughout the country and sponsored a training program on fair lending for Reserve Bank staff members that was instrumental in developing and launching a national community affairs Internet site linking the web sites of the twelve Reserve Banks.

Concern for the relatively limited availability of technology to low-income inner city and rural households was the focus of a conference sponsored by the Federal Reserve Bank of New York. This issue was also discussed at a community reinvestment conference hosted by the Federal Reserve Bank of San Francisco.

The Federal Reserve Bank of Boston convened a meeting to present strategies and tools for faith-based groups that are working to address critical community development issues.

In response to concerns regarding the effect of credit scoring on the availability of credit to underserved populations, a collaboration of staff members from the Board and the Boston, Chicago, Cleveland, and San Francisco Reserve Banks initiated a five-part report exploring various aspects and effects of credit scoring.

During 2000, Community Affairs Program officers continued working on affordable housing. Board staff members advised a national community development organization on the issue as well as the Rural Home Loan Partnership (RHLP), an interagency partnership committed to providing affordable housing in rural communities. The Federal Reserve Bank of Dallas hosted a financing workshop for the RHLP, and community affairs staff members at the Atlanta Reserve Bank provided signifi-

cant assistance for an RHLP meeting in Orlando, Florida.

Given the many challenges in rural and Native American communities, public-private partnerships are critical to successful community development. To promote such collaborations in rural communities, the Federal Reserve Bank of Kansas City sponsored a series of roundtables in cooperation with the Atlanta, Chicago, Cleveland, Dallas, Minneapolis, and San Francisco Reserve Banks. These sessions focused on identifying the strengths and challenges unique to rural areas; findings of these meetings and resulting policy recommendations were published by the Kansas City Reserve Bank. Similarly, the Federal Reserve Bank of San Francisco convened task force meetings among various tribal leaders to explore ways of overcoming the barriers to credit faced by residents and business owners on Native American reservations.

### **Economic Effects of the Electronic Fund Transfer Act**

As required by the Electronic Fund Transfer Act (EFTA), the Board monitors the effects of the act on the compliance costs and consumer benefits related to electronic fund transfer (EFT) services.

The proportion of U.S. households using EFT services has grown over the past decade at an annual rate of about 2 to 3 percent, according to consumer surveys (the most recent in 1998). Approximately 85 percent of households have one or more EFT features on their accounts at financial institutions.

Automated teller machines (ATMs) remain the most widely used EFT service. About two-thirds of U.S. households have an ATM card. During 2000

the average monthly number of ATM transactions increased to 1.1 billion, from 907.4 million for 1999, and the number of installed ATMs rose about 20 percent, to 273,000.

Direct deposit is another widely used EFT service. About 60 percent of U.S. households have funds deposited directly into their transaction accounts (checking or savings). Use of the service is particularly common in the public sector, accounting for 77 percent of social security payments, 92 percent of federal salary and retirement payments, and 29 percent of federal income tax refunds.

A less widely used EFT payment mechanism is direct bill paying. About 36 percent of U.S. households have payments automatically deducted from their accounts.

About one-third of U.S. households have debit cards, which consumers use at merchant terminals to debit their transaction accounts. These point-of-sale (POS) systems account for a fairly small share of electronic transactions, but their use continued to grow rapidly in 2000. The average monthly number of POS transactions rose about 28 percent, from 202.3 million in 1999 to 258.9 million in 2000, and the number of POS terminals rose about 19 percent to 2.8 million.

The incremental costs associated with the EFTA are difficult to quantify because no one knows how industry practices would have evolved in the absence of statutory requirements. The benefits of the EFTA are also difficult to measure because they cannot be isolated from consumer protections that would have been provided in the absence of regulation. The available evidence suggests no serious consumer problems with EFTA (see "Agency Reports on Compliance with Consumer Regulations" below).

## **Compliance**

The Federal Reserve System's compliance activities in 2000 included conducting and overseeing examinations of state member banks; training System compliance examiners; and participating in the compliance activities of the Federal Financial Institutions Examination Council (FFIEC). The System also continued its implementation of risk-focused examination procedures, which enhance the efficiency and effectiveness of System compliance examinations.

### **Compliance Examinations**

The Federal Reserve System's compliance examination program ensures that state member banks and foreign banking organizations subject to Federal Reserve examination comply with federal laws protecting consumers in the provision of financial services. During the 2000 reporting period (July 1, 1999, through June 30, 2000), the Federal Reserve conducted 526 examinations for compliance with consumer protection laws: 408 examinations of state member banks and 118 of foreign banking organizations.<sup>6</sup>

### **Examiner Training**

Examiners who are well versed in the consumer protection laws, fair lending laws, and the Community Reinvestment Act (CRA) are critical to the success

of the Board's compliance program. Hence, the type and timeliness of training opportunities are important. Reserve Bank examiners with little or no field experience attend a two-week basic compliance course; and examiners with six to eighteen months of field experience attend a two-week advanced course, a two-week course in techniques for fair lending examinations, and a one-week course in CRA examination techniques.

In addition, in 2000 the System introduced a new course on commercial lending essentials for consumer affairs compliance examiners. The course is taught by safety and soundness examiners and by other Board staff members who have previous experience as commercial lenders.

During the 2000 reporting period, 204 individuals attended eleven compliance examination schools. The schools included two sessions of the System's basic compliance course, two of the advanced compliance course, three in fair lending examination techniques, and three in CRA examination techniques.

### **Participation in FFIEC Activities**

Through the cooperation of its member agencies, the FFIEC develops uniform examination principles, standards, and report forms.<sup>7</sup> In 2000 the member agencies continued working to improve coordination of consumer compliance and CRA examination activities. Actions to promote uniformity among the federal supervisors of financial institutions included issuing new interagency examination procedures for the Homeowners Protection Act of 1998, which requires lenders or servicers to provide information about private mortgage

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6. The foreign banking organizations examined by the Federal Reserve are organizations operating under section 25 or 25(a) of the Federal Reserve Act (Edge Act and agreement corporations) and state-chartered commercial lending companies owned or controlled by foreign banks. These institutions are not subject to the Community Reinvestment Act and, in comparison with state member banks, they typically engage in relatively few activities that are covered by consumer protection laws.

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7. For the member agencies of the FFIEC, see note 4.

insurance (PMI) on loans secured by the consumer's primary residence.

In addition, the FFIEC is currently developing interagency examination procedures for the agencies' privacy regulations. The privacy regulations contain notice requirements and place restrictions on a financial institution's disclosure of nonpublic personal information about consumers to nonaffiliated third parties. The FFIEC is also developing interagency examination procedures for the Children's Online Privacy Protection Act of 1998, which addresses the collection, disclosure, and use of personal information about children obtained through an Internet web site or other online service.

### **Community Reinvestment Act**

The Federal Reserve assesses the CRA performance of state member banks through compliance examinations. In addition, the Board considers CRA ratings (as well as other factors) when acting on applications from state member banks and bank holding companies for mergers, acquisitions, and certain other actions. The Federal Reserve's program for fostering better bank performance under the CRA includes the following tasks:

- Examining institutions to assess compliance with the CRA
- Disseminating information on community development techniques to bankers and the public through community affairs offices at the Reserve Banks
- Performing CRA analyses in connection with applications from state member banks and bank holding companies.

During the 2000 reporting period, the Federal Reserve conducted 260 CRA

examinations. Of the banks examined, 52 were rated "outstanding" in meeting community credit needs, 202 were rated "satisfactory," 5 were rated "needs to improve," and 1 was rated as being in "substantial noncompliance."

Fewer banks were examined during the 2000 reporting period than during the 1999 reporting period because the GLB Act, which became law in November 1999, extended the length of time between CRA examinations for financial institutions with assets of less than \$250 million and a CRA rating of satisfactory or outstanding. With few exceptions, the law requires that banks rated satisfactory for CRA performance be examined no more than once every forty-eight months (up from once every twenty-four months) and that banks rated outstanding be examined no more than once every sixty months (up from once every thirty-six months).

### **Agency Reports on Compliance with Consumer Regulations**

The Board reports annually on agency compliance with Regulation B (which implements the Equal Credit Opportunity Act); Regulation E (Electronic Fund Transfer Act); Regulation M (Consumer Leasing Act); Regulation Z (Truth in Lending Act); Regulation CC (Expedited Funds Availability Act); Regulation DD (Truth in Savings Act); and Regulation AA (Unfair or Deceptive Acts or Practices). The Board assembles compliance data from the Reserve Banks and also collects data from the FFIEC agencies and from other federal supervisory agencies.<sup>8</sup>

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8. The agencies use different methods to compile compliance data. Accordingly, the data presented here regarding percentages of financial institutions supervised or examined support only general conclusions.

A summary of the reported compliance data for the 2000 reporting period (July 1, 1999 through June 30, 2000) follows. In general, the overall level of compliance in 2000 was similar to that in 1999. As in past years, the level of compliance varied considerably from regulation to regulation.

### **Regulation B (Equal Credit Opportunity)**

The FFIEC agencies reported that 81 percent of the institutions examined during the 2000 reporting period were in compliance with Regulation B, compared with 78 percent for the 1999 reporting period. Of the institutions not in compliance, 68 percent had one to five violations. The most frequent violations involved the failure to take one or more of the following actions:

- Provide a written notice of credit denial or other adverse action containing a statement of the action taken, the name and address of the creditor, a Regulation B notice of rights, and the name and address of the federal agency that enforces compliance
- Provide a statement of reasons for credit denial or other adverse action that is specific and indicates the principal reasons for the credit denial or other adverse action
- Collect information for monitoring purposes about the race or national origin, sex, marital status, and age of applicants seeking credit primarily for the purchase or refinancing of a principal residence
- Notify the credit applicant of the action taken within the time frames specified in the regulation
- Refrain from requesting the race, national origin, or sex of an applicant in transactions not covered by the monitoring requirements.

The OTS issued four formal enforcement actions that contained provisions relating to Regulation B; the FDIC issued one.

In 2000 the Federal Trade Commission (FTC), in conjunction with various other agencies, obtained consent orders against a subprime mortgage lender and a subprime finance company for alleged violations of the Equal Credit Opportunity Act (ECOA). The alleged violations included, among others, failing to provide applicants with written notice of adverse action on credit applications and failing to provide adequate notices of adverse action to loan applicants. Under the consent decrees, the defendants agreed to the entry of a permanent injunction and agreed to pay civil money penalties.

The FTC also continued litigation against a mortgage lender for violations of the ECOA. The allegation included, among others, failure to take written applications for mortgage loans, failure to collect monitoring information on mortgage loan applicants, and providing inadequate notices of adverse action to loan applicants. The FTC is seeking civil money penalties and injunctive relief.

The other agencies that enforce the ECOA—the Farm Credit Administration (FCA); the Department of Transportation (DOT); the Securities and Exchange Commission (SEC); the Small Business Administration; and the Grain Inspection, Packers and Stockyards Administration of the Department of Agriculture—reported substantial compliance among the entities they supervise. The FCA's examination and enforcement activities revealed certain violations of ECOA, most of them due to creditors' failure to collect information for monitoring purposes and failure to comply with rules regarding adverse



action notices; however, no formal actions were initiated.

### Regulation E (Electronic Fund Transfers)

The FFIEC agencies reported that approximately 94 percent of the institutions examined during the 2000 reporting period were in compliance with Regulation E, compared with 95 percent for the 1999 reporting period. Financial institutions most frequently failed to comply with the following requirements:

- Investigate an alleged error promptly after receiving a notice of the error
- Determine whether an error occurred and transmit the results of the investigation and determination to the consumer within ten business days
- Credit the customer's account in the amount of the alleged error within ten business days of receiving the error notice.

The OTS issued one formal enforcement action that contained provisions relating to Regulation E.

In 2000 the FTC continued its consumer and business education efforts. The SEC reported that no violations of Regulation E were detected in examinations of registered broker-dealers conducted by self-regulatory organizations.

### Regulation M (Consumer Leasing Act)

The FFIEC agencies reported substantial compliance with Regulation M for the 2000 reporting period. As in 1999, more than 99 percent of the institutions examined were in compliance. The few violations noted involved fail-

ure to adhere to specific disclosure requirements.

The FTC issued final decisions and orders in two cases involving deceptive motor vehicle promotions on the Internet. The complaints in these cases charged two companies and their chief executive officers with running deceptive advertisements. The complaints alleged that the companies failed to disclose, or failed to disclose adequately, the additional costs in the lease offers and that a security deposit was required. Also, key cost terms were provided in inconspicuous or unreadable fine print in violation of the Consumer Leasing Act (CLA). The orders in these cases bar the companies and their chief executives from, among other things, misrepresenting the costs or terms of vehicle leasing.

In addition, the FTC issued final decisions and orders concerning deceptive vehicle lease advertisements in six cases involving dealerships in Pennsylvania. The orders in these six cases require the dealerships to make clear and accurate cost disclosures in lease and credit advertisements and to comply with all provisions of the CLA.

### Regulation Z (Truth in Lending)

The FFIEC agencies reported that 77 percent of the institutions examined during the 2000 reporting period were in compliance with Regulation Z, compared with 74 percent for the 1999 reporting period. The Board, the OTS, the FDIC, and the NCUA reported an increase in compliance, while the OCC reported an unchanged level of compliance. The FFIEC agencies indicated that of the institutions not in compliance, 64 percent were in the lowest-frequency category (having one to five violations) compared with 63 percent in 1999.

The violations of Regulation Z most often observed were

- Inaccurate disclosure of the finance charge, payment schedule, annual percentage rate, security interest in collateral, and amount financed
- Failure to disclose the annual percentage rate on a periodic statement using the term "Annual Percentage Rate"
- Failure to provide disclosures within three business days of receiving a residential mortgage application covered under the Real Estate Settlement Procedures Act
- Failure to ensure that disclosures reflect the terms of the legal obligation between the parties.

The OTS issued five formal enforcement actions subject to provisions of Regulation Z; the FDIC and OCC each issued one.

With respect to disclosure of the annual percentage rate or finance charge, the statute requires reimbursement for certain inaccuracies. Altogether, a total of 137 institutions supervised by the Federal Reserve, the FDIC, or the OTS were required, under the Interagency Enforcement Policy on Regulation Z, to refund about \$784,000 to consumers in 2000 because of improper disclosures.

In 2000 the FTC obtained consent judgments against two mortgage companies for alleged violations of the Home Ownership and Equity Protection Act and the Truth in Lending Act (TILA). In other enforcement actions the FTC

- Obtained a consent judgment pertaining to credit accident and health insurance against a finance company and its owner
- Issued a final order against a finance company regarding debt consolidation

loans involving alleged violations of TILA

- Issued consent judgments against several companies and their principals in a case involving violations of TILA in connection with payday loans
- Continued to litigate a complaint the FTC had filed in federal district court in 1998. The complaint charged a mortgage lender in the Washington, D.C., area and its owner with violating TILA in connection with alleged deceptive and unfair practices in home mortgage lending. A trial date has not been set for this case
- Filed and amended a complaint in federal district court charging a company that sold vacation travel packages with violating TILA by failing to issue credits to consumers in credit card transactions after telling the consumers that the credit would be provided.

During 2000 the FTC issued a consumer publication *Payday Loans—Costly Cash* and updated various other publications. In addition, the FTC is reviewing the effect on TILA and the CLA of the Electronic Signatures in Global and National Commerce Act (the E-Sign Act) and has commenced a study in conjunction with the Department of Commerce regarding the consumer consent provisions of the E-Sign Act.

The DOT is currently investigating one potential TILA-related case involving an air carrier's timeliness in processing customer requests for credit card refunds. In 2000 the DOT continued to prosecute a cease-and-desist consent order issued in 1993 against a travel agency and a charter operator. The complaint alleged that the two organizations violated Regulation Z by routinely failing to send credit statements for refund requests to credit card issuers within seven days of receiving fully docu-

mented credit refund requests from customers.

### **Regulation AA (Unfair or Deceptive Acts or Practices)**

The three bank regulators with responsibility for enforcing Regulation AA's Credit Practices Rule—the Federal Reserve, the FDIC, and the OCC—reported that 99 percent of the institutions examined during the 2000 reporting period were in compliance. The most frequent violations were

- Failure to provide a clear, conspicuous disclosure regarding a cosigner's liability for a debt
- Entering into a consumer credit contract that contains a nonpossessory security interest in household goods other than a purchase money security interest.

The FDIC issued one formal enforcement action that contained provisions relating to Regulation AA.

### **Regulation CC (Availability of Funds and Collection of Checks)**

The FFIEC agencies reported that 90 percent of institutions examined during the 2000 reporting period were in compliance with Regulation CC, compared with 91 percent for the 1999 reporting period. Of the institutions not in compliance, 67 percent had one to five violations. Institutions most frequently failed to comply with the following requirements:

- Make funds from certain checks, both local and nonlocal, available for withdrawal within the times prescribed by the regulation

- Follow special procedures for exceptions for large dollar deposits
- Provide exception notices about funds availability, including all required information.

No formal enforcement actions for violations of the regulation were issued during the period.

### **Regulation DD (Truth in Savings)**

The FFIEC agencies reported that 88 percent of institutions examined during the 2000 reporting period were in full compliance with Regulation DD. Institutions most frequently failed to comply with the following requirements:

- Use advertisements that are accurate and not misleading
- State the rate of return as an annual percentage yield in an advertisement
- State required additional information in advertisements containing the annual percentage yield
- Provide all applicable information on account disclosures.

## **Consumer Complaints**

The Federal Reserve investigates complaints against state member banks and forwards to the appropriate enforcement agency complaints that involve other creditors and businesses (see table). The Federal Reserve also monitors and analyzes complaints about unregulated practices.

During 2000 the Board developed a letter-generating system that uses database information to produce uniform letters of acknowledgment to complainants. The system is a new component to Complaints Analysis Evaluation System

Consumer Complaints against State Member Banks and Other Institutions Received by the Federal Reserve System, 2000

Subject	State member banks	Other institutions <sup>1</sup>	Total
Regulation B (Equal Credit Opportunity) .....	57	45	102
Regulation E (Electronic Fund Transfers) .....	55	67	122
Regulation M (Consumer Leasing) .....	12	24	36
Regulation Q (Payment of Interest) .....	0	1	1
Regulation Z (Truth in Lending) .....	374	438	812
Regulation BB (Community Reinvestment) .....	0	1	1
Regulation CC (Expedited Funds Availability) .....	24	36	60
Regulation DD (Truth in Savings) .....	65	40	105
Fair Credit Reporting Act .....	144	286	430
Fair Debt Collection Practices Act .....	8	15	23
Fair Housing Act .....	5	2	7
Flood insurance .....	2	7	9
Regulations T, U, and X .....	0	1	1
Real Estate Settlement Procedures Act .....	7	41	48
Unregulated practices .....	1,659	1,539	3,198
<b>Total</b> .....	<b>2,412</b>	<b>2,543</b>	<b>4,955</b>

1. Complaints against these institutions were referred to the appropriate regulatory agencies.

and Reports (CAESAR), which tracks complaints and inquiries. The letters system was implemented at the Federal Reserve Bank of New York in December 2000 and is expected to be fully implemented at all the Reserve Banks by midyear 2001.

Throughout 2000 the Reserve Banks continued to send staff members to the Board for several weeks at a time to gain familiarity with operations in Washington for handling complaints.

### Complaints against State Member Banks

In 2000 the Federal Reserve received about 5,000 complaints—by mail, by telephone, in person, and electronically via the Internet. About half of the complaints were against state member banks (see tables). Of these, almost 60 percent involved loan functions: 3 percent alleged discrimination on a prohibited basis; and 56 percent concerned a variety of credit practices, such as credit denial on a basis not prohibited by law (for example, credit history or length of

residence), or the release or use of consumers' credit information. Thirty percent of the complaints against state member banks involved disputes about interest on deposits and general deposit account practices; the remaining 11 percent concerned disputes about electronic fund transfers, trust services, or other practices.

During 2000 the System completed the investigation of about 200 complaints that were pending at year-end 1999 against state member banks, finding six violations of regulations. In most cases, Reserve Bank investigations found that banks had correctly handled customer accounts. Nonetheless, the banks chose to reimburse or otherwise accommodate the consumer in nearly half of these situations.

The Federal Reserve received approximately 1,900 inquiries about consumer credit and banking policies and practices. In responding to these inquiries, the Board and Federal Reserve Banks gave explanations of laws and banking practices and provided relevant publications.

Consumer Complaints Received by the Federal Reserve System,  
by Subject of Complaint, 2000

Subject of complaint	Complaints against state member banks					
	Total		Not investigated		Investigated	
	Number	Percent	Unable to obtain sufficient information from consumer	Explanation of law provided to consumer	Bank legally correct	
					No reimbursement or other accommodation	Goodwill reimbursement or other accommodation
<b>Loans</b>						
Discrimination alleged						
Real estate loans .....	21	1	0	6	2	0
Credit cards .....	21	1	0	1	11	3
Other loans .....	15	1	0	2	3	0
Other type of complaint						
Real estate loans .....	190	8	5	13	63	27
Credit cards .....	981	40	15	18	275	521
Other loans .....	184	8	3	19	80	20
Deposits .....	734	30	20	96	299	106
Electronic fund transfers .....	55	2	2	3	14	12
Trust services .....	42	2	3	17	12	2
Other .....	169	7	10	12	78	18
<b>Total .....</b>	<b>2,412</b>	<b>100</b>	<b>58</b>	<b>187</b>	<b>837</b>	<b>709</b>

## Unregulated Practices

As required by section 18(f) of the Federal Trade Commission Act, the Board monitors complaints about banking practices that are not subject to existing regulations and identifies those that concern possible unfair or deceptive practices. In 2000 the Board received complaints about a wide range of unregulated practices. Three of the four categories that received the most com-

plaints involved credit cards: penalty charges (161), interest rates and terms (130), and varied other problems (158). The fourth category involved complaints about charges and procedures for checking accounts with insufficient funds (137). Among the wide range of other issues raised were check-cashing problems encountered by individuals who did not have an account at the institution and consumer dissatisfaction with fees for bank loans or deposit accounts.

## Consumer Complaints Received—Continued

Complaints against state member banks						Referred to other agencies	Total complaints
Investigated					Pending, December 31		
Customer error	Bank error	Factual or contractual dispute—resolvable only by courts	Possible bank violation—bank took corrective action	Matter in litigation			
0	1	0	2	0	10	19	40
0	0	0	0	0	6	8	29
0	0	0	2	2	6	18	33
3	52	6	2	8	11	380	570
2	69	4	5	0	72	789	1,770
1	37	7	0	8	9	371	555
0	115	26	2	14	56	596	1,330
0	13	0	5	1	5	67	122
0	3	1	0	4	0	12	54
8	27	2	0	8	6	283	452
14	317	46	18	45	181	2,543	4,955

## Complaint Referrals to HUD

In 2000 the Federal Reserve referred seventeen complaints to HUD that alleged state member bank violations of the Fair Housing Act. The referrals were made in accordance with a memorandum of understanding between HUD and the federal bank regulatory agen-

cies. Investigations were completed for nine of the seventeen complaints. Seven of the nine investigations revealed no evidence of illegal discrimination. In the other two cases, the parties were seeking resolution through the courts; the Federal Reserve does not intervene in such matters. ■

## *Banking Supervision and Regulation*

U.S. bank earnings remained strong in 2000, although they were off slightly from the record performance in 1999. Credit weaknesses, revealed as the economy slowed, required slightly higher loss provisions, while continued price competition and slow deposit growth compressed net interest margins for many banks. Noninterest income, an important source of growth in industry revenue in recent years, also slipped as a result of reduced income from private equity investments, lower trading income, and reduced investment management fees, all of which mostly affected large banks. Nonperforming loans and foreclosed real estate increased 33 percent from historically low levels. The annual interagency review of large syndicated loans showed that most of the deterioration was in commercial loans, particularly in the financial services and manufacturing sectors. Nonetheless, the volume of nonperforming assets remained well below the heights (associated with problems in the commercial real estate market) that were reached in the early 1990s.

Although challenged by a slowing economy and changing business practices and conditions, the U.S. banking system remains sound. Problems with credit quality have increased, but the industry's overall portfolio quality, earnings, and capital levels remain strong by nearly any historical measure.

In 2000 the Federal Reserve implemented provisions of the Gramm-Leach-Bliley Act. The act, passed in November 1999, removed long-standing barriers between commercial banking and securities and insurance underwriting. Although relatively few institutions

had expanded into these newly authorized activities by year-end 2000, more than 480 bank holding companies had sought and received authority to do so by meeting the legal standards to be declared a financial holding company (FHC).

Although the future actions of FHCs may depend heavily on what specific opportunities banking organizations find in the years to come, this demonstrated interest in becoming an FHC suggests that many organizations, both large and small, are likely to expand into new areas of financial services. As the "umbrella supervisor" of all FHCs, the Federal Reserve must rely to the greatest extent possible on the supervisory efforts of an institution's primary supervisor and functional regulator to ensure that nonbank activities do not present an unacceptable risk to affiliated banks. Given the greater need for interagency work, the Federal Reserve has increased its coordination and information sharing with, among others, the Securities and Exchange Commission, which oversees activities of registered broker-dealers and other firms engaged in securities activities, and with the state insurance commissions.

In recent years, the Federal Reserve has actively sought to encourage banks to maintain strong underwriting standards and has warned them to improve their processes for measuring and managing credit risk. Despite such encouragement and warning, recently announced credit losses have been largely attributable to an undue relaxation of lending standards during the 1997–99 period. Banks have tightened their standards, but much work remains

to be done by them in evaluating exposures, not only when a loan is first approved but under a range of simulated stressful conditions. Under the terms of existing guidance for proper risk management, the Federal Reserve supervisory and examination staff has been looking more closely at banks' internal systems for rating loans and for evaluating capital adequacy.

The Federal Reserve's emphasis on advancing sound risk management practices has contributed to important initiatives being undertaken on an international scale by the Basel Committee on Banking Supervision, which operates under the auspices of the Bank for International Settlements, in Basel, Switzerland. The committee has been developing a new capital standard for internationally active banks that is far more risk sensitive than the current standard (see box). The new approach builds on an institution's internal credit risk models and its own calculations of how much capital it needs. The Federal Reserve staff assisted the committee in the development of the proposal, which was issued for public comment in January 2001. Although its implementation is several years away, this proposal and its accompanying risk management standards should improve the ability of supervisors and banking organizations to detect and control risks within the banking system.

### **Scope of Responsibilities for Supervision and Regulation**

The Federal Reserve is the federal supervisor and regulator of all U.S. bank holding companies (including financial holding companies formed under the authority of the Gramm-Leach-Bliley Act) and of state-chartered commercial banks that are members of the Federal Reserve System. In overseeing these

organizations, the Federal Reserve primarily seeks to promote their safe and sound operation and their compliance with laws and regulations, including the Bank Secrecy Act and consumer and civil rights laws.<sup>1</sup>

The Federal Reserve also has responsibility for the supervision of all Edge Act and agreement corporations; the international operations of state member banks and U.S. bank holding companies; and the operations of foreign banking companies in the United States.<sup>2</sup>

The Federal Reserve exercises important regulatory influence over entry into the U.S. banking system and the structure of the system through its administration of the Bank Holding Company Act, the Bank Merger Act (for state member banks), the Change in Bank Control Act (for bank holding companies and state member banks), and the International Banking Act. The Federal Reserve is also responsible for imposing margin requirements on securities transactions. In carrying out these responsibilities, the Federal Reserve coordinates its supervisory activities with other federal banking agencies, state agencies,

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1. The Board's Division of Consumer and Community Affairs is responsible for coordinating the Federal Reserve's supervisory activities with regard to the compliance of banking organizations with consumer and civil rights laws. To carry out this responsibility, the Federal Reserve trains a number of its bank examiners to evaluate institutions with regard to such compliance. The chapter of this volume covering consumer and community affairs describes these regulatory responsibilities. Compliance with other banking statutes and regulations, which is treated in this chapter, is the responsibility of the Board's Division of Banking Supervision and Regulation and the Federal Reserve Banks, whose examiners also check for safety and soundness.

2. Edge Act corporations, chartered by the Federal Reserve, and agreement corporations, chartered by the states, provide all segments of the U.S. economy with a means of financing international trade, especially exports.



and the bank regulatory agencies of other nations.

### **Supervision for Safety and Soundness**

To ensure the safety and soundness of banking organizations, the Federal Reserve conducts on-site examinations and inspections and off-site surveillance and monitoring. It also undertakes enforcement and other supervisory actions.

#### **Examinations and Inspections**

The Federal Reserve conducts examinations of state member banks, branches and agencies of foreign banks, Edge Act corporations, and agreement corporations; in a process distinct from examinations, it conducts inspections of holding companies and their nonbank subsidiaries. Pre-examination planning and on-site review of operations are integral parts of ensuring the safety and soundness of financial institutions. Whether an examination or an inspection, the review entails (1) an assessment of the quality of the processes in place to identify, measure, monitor, and control risks, (2) an appraisal of the quality of the institution's assets, (3) an evaluation of management, including an assessment of internal policies, procedures, controls, and operations, (4) an assessment of the key financial factors of capital, earnings, liquidity, and sensitivity to market risk, and (5) a review for compliance with applicable laws and regulations.

#### *State Member Banks*

At the end of 2000, 990 state-chartered banks (excluding nondepository trust companies and private banks) were members of the Federal Reserve Sys-

tem. These banks represented approximately 12.0 percent of all insured U.S. commercial banks and held approximately 26.7 percent of all insured commercial bank assets in the United States.

The guidelines for Federal Reserve examinations of state member banks are fully consistent with section 10 of the Federal Deposit Insurance Act, as amended by section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and by the Riegle Community Development and Regulatory Improvement Act of 1994. A full-scope, on-site examination of these banks is required at least once a year; certain well-capitalized, well-managed institutions having assets of less than \$250 million may be examined once every eighteen months.

During 2000 the Federal Reserve Banks conducted 589 examinations of state member banks (some of them jointly with state agencies), and state banking departments conducted 273 independent examinations of state member banks.

#### *Bank Holding Companies*

At year-end 2000 the number of top-tier U.S. bank holding companies totaled 5,109. These organizations had 6,483 subsidiary banks and held approximately 93 percent of all commercial bank assets.

Federal Reserve guidelines call for annual inspections of large bank holding companies as well as smaller companies that have significant nonbank assets. In judging the financial condition of subsidiary banks, Federal Reserve examiners consult the examination reports of the federal and state banking authorities that have primary responsibility for the supervision of these banks, thereby minimizing duplication of effort and reducing the burden on banking organi-

## The New Basel Capital Accord

*Getting the proposed risk-based capital numbers correct, both in science and as an art, is especially critical for most complex organizations. The current one-size-fits-all regulatory capital regime, as you know, has led increasingly to a gaming of the regulatory requirements.*

Laurence H. Meyer, *Member, Board of Governors*  
June 1, 2000

On January 16, 2001, the Basel Committee on Banking Supervision issued its second proposal on the New Basel Capital Accord. The proposal describes several methods by which banks could determine their minimum regulatory capital requirements.

The new accord has three mutually reinforcing “pillars” that make up the framework for assessing capital adequacy in a bank. Pillar 1 is the minimum regulatory capital charge. The pillar 1 capital requirement includes both a standardized approach, updated since the 1988 Basel Capital Accord, and the new, internal-risk-based (IRB) approach.

Pillar 2 is supervisory review. It is intended to ensure that banks have adequate capital to support all the risks in their business and to encourage banks to develop better techniques for monitoring and managing these risks. Pillar 2 encourages supervisors to assess banks’ internal approaches to capital allocation and internal assessments of capital adequacy and, subject to national discretion, provides an opportunity for the supervisor to indicate where such approaches do not appear to be sufficient. Seen another way, pillar 2 helps focus supervisors on other means of addressing risks in a bank’s portfolio, such as improving overall risk management techniques and internal controls.

Pillar 3 is market discipline. Market discipline has the potential to reinforce capital regulation and other supervisory efforts to ensure the safety and soundness of the banking system. Accordingly, the committee is proposing a wide range of disclosure initiatives designed to make the risk and capital positions of a bank more transparent. As a bank begins to use the more advanced methodologies, such as the IRB approach, the new accord will require a significant increase in the level of disclosure. In essence, the trade-off for greater reliance on a bank’s own assessment of capital adequacy is greater transparency.

The revised standardized approach under pillar 1 enhances the “risk bucketing” approach of the 1988 accord by providing greater, though still limited, risk sensitivity. To create an even more risk-sensitive framework, the proposal includes additional features: the refinement and addition of risk buckets; the use of external credit ratings, where present, to determine risk weights for sovereigns, banks, and corporate exposures; and a broader recognition of types of financial collateral and guarantees. The proposal also removes the 50 percent cap on risk weights for derivatives contracts and increases to 20 percent the credit conversion factor for business commitments of less than one year.

To use the IRB approach, banks must meet an extensive set of eligibility standards. The standards embody sound risk management practices and are necessary to provide supervisors with adequate confidence in banks' internal risk estimates. Because the requirements are qualitative, national supervisors will need to evaluate compliance with them to determine which banks may apply the new framework. The requirements vary by type of exposure as well by whether the bank uses the "foundation" or "advanced" IRB framework.

To calculate the amount of capital necessary to support a bank's economic risks, the IRB approach builds on internal credit risk practices of banks and on the internal processes used by some leading institutions. For each credit exposure, the IRB approach requires the following information: the amount at risk in the event of default, the borrower's probability of default, the loss to the bank that would occur in the event of default, and the credit facility's remaining maturity.

The foundation IRB framework uses conservative supervisory judgments to specify the amount at risk and the loss in the event of default. In effect, in exchange for less detailed bank-specific information and burden, the capital charges are less bank-specific and more standardized.

The advanced IRB framework has been designed to provide banks with maximum flexibility in calculating their regulatory capital requirements, subject to the constraints of prudential regulation, current banking practices and capabilities, and the need for sufficiently compatible standards among countries to maintain competitive equity among banking organizations worldwide. The advanced framework would permit banks to apply their own data and judgments regarding most

key factors affecting credit risk, provided they meet the minimum requirements and receive supervisory approval to use their estimates in calculating regulatory capital requirements.

The new accord is intended to provide banks with incentives to evolve toward the advanced IRB framework while ensuring that banking organizations remain competitive and adequately capitalized, regardless of the technique used. Sophisticated methods of risk measurement and management are particularly important for large, complex banking organizations because such organizations, should they encounter difficulties, could pose systemic risk.

One of the most significant changes in the new accord is the proposal for an operational risk charge. The charge, which is expected to represent, on average, about 20 percent of the minimum regulatory capital charge, is based upon the following concept of operational risk: *the risk of direct or indirect loss to the institution resulting from shortcomings of internal processes, people, and systems or from external events*. Although the focus of operational risk is on the pillar 1 capital charge, it also brings in elements of pillar 2 (strong control environment), and pillar 3 (disclosure).

The deadline for comment on the New Basel Capital Accord is May 31, 2001, and the committee plans to release a final version by year-end 2001. On the basis of that release date, the implementation date has been set for 2004 to allow for domestic rulemaking processes and to allow banks and supervisors time to prepare.

The 1988 accord applied to all banks in the United States. The extent to which the new accord will be applied will be decided on the basis of public comment and further refinement of the proposal.

zations. In 2000, Federal Reserve examiners conducted 1,247 bank holding company inspections, of which 1,109 were on-site and 138 were off-site, and state examiners conducted 70 independent inspections.

Small, non-complex bank holding companies—those that have less than \$1 billion in consolidated assets, do not have debt outstanding to the public, and do not engage in significant nonbank activities—are subject to a special supervisory program that became effective in 1997. The program permits a more flexible approach to supervising those entities in a risk-focused environment. Each such holding company is subject to off-site review once during the examination cycle for the company's lead bank. In 2000 the Federal Reserve conducted 2,474 reviews of these companies.

### *Financial Holding Companies*

As of year-end 2000, 463 domestic bank holding companies and 21 foreign banking organizations had received financial holding company status. Of the domestic institutions, 32 financial holding companies had consolidated assets of \$15 billion or more, 59 between \$1 billion and \$15 billion, 34 between \$500 million and \$1 billion, and 338 with less than \$500 million.

### *Specialized Examinations*

The Federal Reserve conducts specialized examinations of banking organizations in the areas of information technology, fiduciary activities, transfer agent activities, and government and municipal securities dealing and brokering. The Federal Reserve also conducts specialized examinations of certain entities, other than banks, brokers, or dealers,

who extend credit subject to the Board's margin regulations.

With the passage of the Gramm–Leach–Bliley Act, the Federal Reserve ceased conducting routine annual examinations of securities underwriting and dealing activities through so-called section 20 subsidiaries of bank holding companies. Under the Gramm–Leach–Bliley Act, the Federal Reserve is generally required to rely upon the supervisory activities of the “functional regulator” for broker–dealer subsidiaries unless the Board has cause to believe that a broker–dealer poses a material risk to an insured depository affiliate. No such examinations were conducted for cause during 2000.

The Federal Reserve has developed a series of case studies to educate System supervisory personnel about communications with, and reliance on, the supervisory activities of functional regulators (for securities, commodities, and insurance regulators) for nonbank activities.

### *Information Technology*

The Federal Reserve reviews the information technology activities of the banking institutions it examines, and it gives the same review to certain independent data centers that provide information technology services to these institutions. During 2000 the Federal Reserve was the lead agency in two examinations of large, multiregional data processing servicers examined in cooperation with the other federal banking agencies. These examinations are conducted in recognition of the importance of information technology to safe and sound operations in the financial industry.

During 2000, information technology reviews at banking organizations were integrated within the overall process of supervision, and thus all safety

and soundness examinations are now expected to include a review of information technology risks and activities.

#### *Fiduciary Activities*

The Federal Reserve has supervisory responsibility for institutions that together hold more than \$15 trillion of assets in various fiduciary capacities. During on-site examination of an institution's fiduciary activities, examiners review its compliance with laws, regulations, general fiduciary principles, and potential conflicts of interest; and they evaluate the institution's management and operations, including its asset and account management, risk management, and audit and control procedures. In 2000, Federal Reserve examiners conducted 141 on-site trust examinations.

#### *Transfer Agents and Securities Clearing Agencies*

As directed by the Securities Exchange Act of 1934, the Federal Reserve conducts specialized examinations of those state member banks and bank holding companies that are registered with the Board as transfer agents. Among other things, transfer agents countersign and monitor the issuance of securities, register the transfer of securities, and exchange or convert securities. On-site examinations focus on the effectiveness of operations and compliance with relevant securities regulations. During 2000, Federal Reserve examiners conducted on-site examinations at 32 of the 117 state member banks and bank holding companies that were registered as transfer agents. Also during the year the Federal Reserve examined one state member limited-purpose trust company that acted as a national securities depository.

#### *Government and Municipal Securities Dealers and Brokers*

The Federal Reserve is responsible for examining state member banks and foreign banks for compliance with the Government Securities Act of 1986 and with regulations of the Department of the Treasury governing dealing and brokering in government securities. Thirty-nine state member banks and nine state branches of foreign banks have notified the Board that they are government securities dealers or brokers not exempt from Treasury's regulations. During 2000 the Federal Reserve conducted 7 examinations of broker-dealer activities in government securities at these institutions.

The Federal Reserve is also responsible for ensuring compliance with the Securities Act Amendments of 1975 by the thirty-two state member banks that acted as municipal securities dealers in 2000. Eight of these institutions were examined in 2000.

#### *Securities Credit Lenders*

Under the Securities Exchange Act of 1934, the Federal Reserve Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. In addition to examining banks under its jurisdiction for compliance with the Board's margin regulations as part of its general examination program, the Federal Reserve maintains a registry of persons other than banks, brokers, and dealers who extend credit subject to the Board's margin regulations. The Federal Reserve may conduct specialized examinations of these lenders if they are not already subject to supervision by the Farm Credit Administration, the National Credit Union Administration, or the Office of Thrift Supervision.

At the end of 2000, 828 lenders other than banks, brokers, or dealers were registered with the Federal Reserve; of these, 640 were under the Federal Reserve's supervision. The Federal Reserve regularly inspects 219 of these lenders either biennially or triennially, according to the type of credit they extend; 112 of the 219 were inspected in 2000 for compliance with Regulation U. The remaining 421 lenders were exempt from periodic on-site inspections by the Federal Reserve but were monitored through the filing of periodic regulatory reports.

### Enforcement Actions and Civil Money Penalties

In 2000 the Federal Reserve initiated 31 enforcement cases involving 44 separate actions, such as cease-and-desist orders, written agreements, removal and prohibition orders, and civil money penalties. The Board of Governors collected \$310,000 in civil money penalties.

All final enforcement orders issued by the Board of Governors and all written agreements executed by the Federal Reserve Banks in 2000 are available to the public and can be accessed from the Board's public web site ([www.federalreserve.gov/boarddocs/enforcement/](http://www.federalreserve.gov/boarddocs/enforcement/)).

In addition to formal enforcement actions, the Federal Reserve Banks and supervised institutions in 2000 completed 128 informal enforcement actions, such as resolutions by boards of directors and memorandums of understanding.

### Risk-Focused Supervision

Over the past several years the Federal Reserve has created a number of programs aimed at enhancing the effectiveness of the supervisory process. The

main objective of these initiatives has been to sharpen the focus on (1) those business activities posing the greatest risk to banking organizations and (2) the organizations' management processes for identifying, measuring, monitoring, and controlling their risks.

### *Large and Regional Banking Organizations*

The risk-focused supervision program for large and regional banking organizations applies to institutions with a functional management structure, a broad array of products, and operations that span multiple supervisory jurisdictions. The supervisory program for these institutions may be implemented with a point-in-time inspection for the smaller institutions and a series of targeted reviews for the larger institutions. For the largest, most complex institutions, the process is continuous, as described in the following section. To minimize the burden on the institution, work is performed off-site to the greatest extent possible. In addition, to reduce the number of requests made to the institution for information, examiners continually review public and regulatory financial reports, market data, information from surveillance screens, and internal management reports.

### *Large, Complex Banking Organizations*

The Federal Reserve applies a risk-focused supervision program to large, complex banking organizations (LCBOs).<sup>3</sup> The key features of the LCBO supervision program are (1) identifying those LCBOs that, based on their

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3. For an overview of the Federal Reserve's LCBO program, see Lisa M. DeFerrari and David E. Palmer, "Supervision of Large Complex Banking Organizations," *Federal Reserve Bulletin*, vol. 97 (February 2001), pp. 47-57.

shared risk characteristics, present the highest level of supervisory risk to the Federal Reserve System, (2) maintaining continual supervision of these institutions to keep current the Federal Reserve's assessment of each organization's condition, (3) assigning to each LCBO a supervisory team composed of Reserve Bank staff members who have skills appropriate for the organization's risk profile (the team leader is the central point of contact, has responsibility for only one LCBO, and is supported by specialists skilled in evaluating the risks of LCBO business activities and functions), and (4) promoting Systemwide and interagency information-sharing through an automated system.

An important element of the program is the sharing of resources across the System. Several initiatives are under way to better deploy supervisory resources Systemwide and to develop risk assessments across groups of institutions to identify emerging trends.

In addition, work continued during 2000 on the first two stages of phase I of the Banking Organization National Desktop (BOND) application. BOND facilitates real-time, secure information sharing and collaboration across the Federal Reserve System and with certain other federal and state regulators to support the risk-focused supervision of domestic and foreign LCBOs. It also improves the Federal Reserve's ability to manage knowledge and data concerning these complex banking organizations. For example, BOND includes reports that address cross-border exposures of LCBOs.

The approach used by the Federal Reserve under the LCBO program is fully consistent with the process prescribed by the Gramm-Leach-Bliley Act for supervising financial holding companies. Umbrella supervision under the act reflects the reality that the

risks associated with financial activities generally cut across legal entities and business lines and that most large and sophisticated financial services companies take a consolidated, or organization-wide, approach to managing their risks.

### *Community Banks*

The risk-focused supervision program for community banks emphasizes that certain elements are critical to the success of the risk-focused process. These elements include adequate planning time, completion of a pre-examination visit, preparation of a detailed scope-of-examination memorandum, thorough documentation of the work done, and preparation of an examination report tailored to the scope of the examination. The framework for risk-focused supervision of community banks was developed jointly with the Federal Deposit Insurance Corporation (FDIC) and has been adopted by the Conference of State Bank Supervisors.

### *Surveillance and Risk Assessment*

To supplement on-site examinations, the Federal Reserve uses automated screening systems to monitor the financial condition and performance of banking organizations. The screening systems analyze supervisory data and regulatory financial reports to identify companies that appear to be weak or deteriorating. The analysis helps to direct examination resources to institutions exhibiting higher risk profiles. Screening systems also assist in the planning of examinations by identifying companies that are engaging in new or complex activities. Currently, separate surveillance programs are run quarterly for state member banks, small shell bank holding companies, and the large and

more complex bank holding companies. The Federal Reserve also produces and distributes a quarterly report, "The Bank Holding Company Performance Report," to assist supervisory staff in evaluating individual companies.

During 2000 the Federal Reserve implemented a watchlist program covering state member banks. This program refines the previous bank surveillance program and sets forth quarterly monitoring procedures for weak and potentially weak state member banks.

The Federal Reserve also works with the other federal banking agencies to enhance and coordinate surveillance activities through the Task Force on Surveillance Systems of the Federal Financial Institutions Examination Council (FFIEC).<sup>4</sup>

### International Activities

The Federal Reserve supervises foreign branches of member banks; overseas investments by member banks, Edge Act and agreement corporations, and bank holding companies; and investments by bank holding companies in export trading companies. It also supervises the activities that foreign banking organizations conduct through entities in the United States, including branches, agencies, representative offices, and subsidiaries.

#### *Foreign-Office Operations of U.S. Banking Organizations*

The Federal Reserve examines the international operations of state member banks, Edge Act corporations, and bank

holding companies principally at the U.S. head offices of these organizations, where the ultimate responsibility for their foreign offices lies. In 2000 the Federal Reserve examined eight foreign branches of state member banks and eighteen foreign subsidiaries of Edge Act corporations and bank holding companies. The examinations abroad were conducted with the cooperation of the supervisory authorities of the countries in which they took place; when appropriate, the examinations were coordinated with the Office of the Comptroller of the Currency. Also, examiners made 13 visits to the overseas offices of U.S. banks to obtain financial and operating information and, in some instances, to evaluate their compliance with corrective measures or to test their adherence to safe and sound banking practices.

#### *Foreign Branches of Member Banks*

At the end of 2000, 70 member banks were operating 953 branches in foreign countries and overseas areas of the United States; 39 national banks were operating 741 of these branches, and 31 state member banks were operating the remaining 212 branches. In addition, 21 nonmember banks were operating 45 branches in foreign countries and overseas areas of the United States.

#### *Edge Act and Agreement Corporations*

Edge Act corporations are international banking organizations chartered by the Board to provide all segments of the U.S. economy with a means of financing international business, especially exports. Agreement corporations are similar organizations, state chartered or federally chartered, that enter into an agreement with the Board to refrain from exercising any power that is not permissible for an Edge Act corporation.

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4. The member agencies of the FFIEC are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.



Under sections 25 and 25(A) of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, which in most cases are subsidiaries of member banks, may (1) conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions and (2) make foreign investments that are broader than those of member banks because they may invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

Edge Act and agreement corporations numbered 76 and operated 24 branches at year-end 2000. These corporations are examined annually.

#### *U.S. Activities of Foreign Banks*

The Federal Reserve has broad authority to supervise and regulate the U.S. activities of foreign banks that engage in banking and related activities in the United States through branches, agencies, representative offices, commercial lending companies, Edge Act corporations, commercial banks, and certain nonbank companies. Foreign banks continue to be significant participants in the U.S. banking system.

As of year-end 2000, 220 foreign banks from 58 countries operated 295 state licensed branches and agencies (of which 13 were insured by the FDIC) as well as 53 branches licensed by the Office of the Comptroller of the Currency (of which 6 had FDIC insurance). These foreign banks also directly owned 18 Edge Act corporations and 3 commercial lending companies; in addition, they held an equity interest of at least 25 percent in 79 U.S. commercial banks. Further, 21 foreign banks and certain of their affiliates were

granted financial holding company status.

Altogether, these U.S. offices of foreign banks at the end of 2000 controlled approximately 19 percent of U.S. commercial banking assets. These foreign banks also operated 111 representative offices; an additional 94 foreign banks operated in the United States solely through a representative office.

State-licensed and federally licensed branches and agencies are examined on-site at least once every eighteen months, either by the Federal Reserve or by a state or other federal regulator; in most cases, on-site examinations are conducted at least once every twelve months, but the period may be extended to eighteen months if the branch or agency meets certain criteria. The Federal Reserve conducted or participated with state and federal regulatory authorities in 288 examinations during 2000.

#### *Joint Program for Supervising the U.S. Operations of Foreign Banking Organizations*

In 1995 the Federal Reserve, in cooperation with the other federal banking agencies and with state banking agencies, formally adopted a joint program for supervising the U.S. operations of foreign banking organizations. The program has two main parts. One part focuses on the examination process for those foreign banking organizations that have multiple U.S. operations and is intended to improve coordination among the various U.S. supervisory agencies. The other part is a review of the financial and operational profile of each organization to assess its general ability to support its U.S. operations and to determine what risks, if any, the organization poses through its U.S. operations. Together, these two pro-

cesses provide critical information to U.S. supervisors in a logical, uniform, and timely manner. During 2000 the program was refined further in light of experience in using it over the past five years.

### *Technical Assistance*

In 2000 the Federal Reserve System continued to provide technical assistance on bank supervisory matters to foreign central banks and supervisory authorities. Technical assistance involves visits by System staff members to foreign authorities as well as consultations with foreign supervisors who visit the Board or the Reserve Banks. Technical assistance in 2000 was concentrated in Latin America, the Far East, and former Soviet bloc countries.

During the year, the Federal Reserve offered supervision training courses in Washington, D.C., and in a number of foreign jurisdictions exclusively for foreign supervisory authorities. System staff also took part in technical assistance and training missions led by the International Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, the Basel Committee on Banking Supervision, and the Financial Stability Institute.

## **Supervisory Policy**

Within the supervisory policy function, the Federal Reserve develops guidance for examiners and financial institutions as well as regulations for financial institutions under the supervision of the Federal Reserve. Staff members also participate in international supervisory forums and provide support for the work of the Federal Financial Institutions Examination Council.

## **Capital Adequacy Standards**

During 2000 the Federal Reserve, together with the FDIC and the Office of the Comptroller of the Currency (OCC), issued an interim final rule that amended the capital standards for securities borrowing transactions. The federal banking agencies—the Federal Reserve, the FDIC, the OCC, and the Office of Thrift Supervision (OTS)—also issued three proposals to amend the capital standards for recourse and direct credit substitutes, residual interests, and securities firms. Furthermore, the agencies issued an advance notice of proposed rulemaking on the possible development of a simplified capital framework for non-complex banking organizations.

### *Securities Borrowing Transactions*

On December 5 the Federal Reserve, together with the FDIC and the OCC, issued an interim rule to revise the capital treatment of cash collateral that is posted in connection with securities borrowing transactions. The effect of the rule is to more appropriately align the capital requirements for these transactions with the risk involved and to provide a capital treatment for U.S. banking organizations that is more in line with the capital treatment applied to their domestic and foreign competitors.<sup>5</sup>

### *Recourse and Direct Credit Substitutes*

On February 17 the Federal Reserve issued a joint proposal with the FDIC, the OCC, and the OTS that would

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5. Specifically, receivables arising from the posting of cash collateral associated with securities borrowing can be treated as collateralized by the market value of the securities borrowed; the rule permits banking organizations operating under the market risk rules to exclude such receivables from risk-weighted assets, subject to certain conditions.

amend the agencies' risk-based capital standards to address the regulatory capital treatment of recourse obligations and direct credit substitutes that expose banks, bank holding companies, and thrift institutions to credit risk. The proposed revisions would use credit ratings to match the risk-based capital assessment more closely to an institution's relative risk of loss in certain asset securitizations. The Basel Committee on Banking Supervision has requested comment on making some of the same revisions to the Basel Capital Accord.

### *Residual Interests*

On September 27 the Federal Reserve, the FDIC, the OCC, and the OTS jointly issued a proposed rule to amend their respective risk-based and leverage capital standards for the treatment of certain residual interests in asset securitizations or other transfers of financial assets. The proposed rule would require that a banking organization hold risk-based capital in an amount equal to the amount of the residual interest that is retained on the balance sheet in a securitization or other transfer of financial assets. The proposal also would limit the amount of residual interests, together with nonmortgage servicing assets and purchased credit card relationships, that may be included in regulatory capital, to 25 percent of tier 1 capital.

### *Claims on Securities Firms*

On December 6 the federal banking agencies proposed to reduce from 100 percent to 20 percent the risk weight accorded to claims on, and claims guaranteed by, qualifying securities firms in countries that are members of the Organisation for Economic Co-operation and Development (OECD). The proposal would bring the

risk weight in line with a 1998 revision to the Basel Capital Accord. Qualifying U.S. securities firms would be broker-dealers registered with the Securities and Exchange Commission (SEC); the firms must be subject to, and comply with, the SEC's net capital rules and be subject to the margin and other regulatory requirements applicable to registered broker-dealers.<sup>6</sup>

### *Simplified Capital Framework for Non-Complex Institutions*

On November 3 the Federal Reserve, along with the other federal banking agencies, issued an advance notice of proposed rulemaking on the possible development of a simplified capital framework for non-complex banking organizations. The options outlined in the proposal include a simplified risk-based framework, a leverage-ratio-only approach, and a modified-leverage-ratio approach. The goal is to potentially relieve the regulatory burden associated with the existing capital rules for many non-complex domestic banking institutions.

### *Integration of Information Technology Examinations*

In February the Federal Reserve issued a new policy governing information technology examinations and banking organizations. Previously, the Federal Reserve separately examined information technology systems of all institu-

6. Qualifying securities firms incorporated in other OECD countries would be those subject to consolidated supervision and regulation, including risk-based capital requirements, in a manner consistent with the Basel Capital Accord. All qualifying securities firms, or their consolidated parents, must have an issuer or debt rating in one of the three highest ratings from a nationally recognized statistical rating organization.

tions conducting in-house processing. In recognition of the importance of information technology to banking operations and to risk management, the new policy directs examiners to integrate the review of information technology activities within the safety and soundness examination process for all institutions. Separate information technology examinations will no longer be routinely conducted.

### Outsourcing

In February the Federal Reserve issued guidance to banks on outsourcing of information and transaction processing activities. The guidance directs banks to establish a program for monitoring and managing risks in such outsourcing arrangements. This guidance formed the basis of interagency guidance on the same topic, which the federal banking agencies issued in November. The interagency guidance reinforces the Federal Reserve's outsourcing guidance and includes supplemental information that banks should consider in establishing and managing outsourcing relationships.

### Development of International Guidance on Supervisory Policies

As a member of the Basel Committee on Banking Supervision, the Federal Reserve participated in negotiations to propose revisions to the international capital regime and aided the development of international supervisory guidance, including supervisory guidance on internal control, accounting, and disclosure practices among banking organizations. The objectives of this guidance are to promote market discipline through greater transparency in financial statements, to encourage sound risk management, and to improve disclosures of qualitative and quantitative information

on bank risk exposures and risk management practices.

The Federal Reserve's goals in these activities are to advance sound supervisory policies for banking institutions and to improve the stability of the international banking system.

### Capital Adequacy

The Federal Reserve contributed to the consultative papers that constitute the proposed New Basel Capital Accord, issued for comment by the Basel committee in January 2001. The Federal Reserve also helped develop a number of supervisory policy papers, reports, and recommendations that were issued by the Basel committee:

- Two papers, released in January 2000, on the committee's proposed amendments to the 1988 Basel Capital Accord

The first, *A New Capital Adequacy Framework: Pillar 3, Market Discipline*, urges a larger role for market discipline in promoting bank capital adequacy by proposing guidelines for bank disclosures.<sup>7</sup> The committee stated that supervisors have a strong interest in facilitating transparency as a lever to strengthen the safety and soundness of the banking system.

The second paper, *Range of Practice in Banks' Internal Rating Systems*, assesses the current state of practice in banks' internal rating systems and processes.

- A revision, issued in September, of the committee's guidance for super-

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7. The title refers to the three pillars, or main sources, of safety and soundness that were articulated in a paper issued by the Basel committee in June 1999; the other two pillars are minimum capital requirements and supervisory review (see box "The New Basel Capital Accord").

visors on managing the settlement risk arising from foreign exchange transactions

The guidance stresses that foreign exchange settlement risk is a form of credit risk that banks should manage, like other credit risks of similar size and duration, through a formal process of measurement and control that includes active oversight by senior management. It also suggests that supervisors focus on whether a bank has evaluated netting and other private-sector initiatives for their potential to reduce settlement risk.

- A revision, also issued in September, of the committee's guidance on credit risk management and disclosure, *Principles for the Management of Credit Risk*

The guidance addresses four topics: (1) establishing an appropriate credit risk environment, (2) operating under a sound credit-granting process, (3) maintaining an appropriate system of credit administration, measurement, and monitoring, and (4) ensuring adequate controls over credit risk.

- The *Electronic Banking Group Initiatives and White Papers*, issued in October, which provides background information and an overview of supervisory and international issues relating to electronic banking.

#### *Internal Control, Accounting, and Disclosure*

The Federal Reserve maintains a direct dialogue with representatives of international banking associations on significant accounting policy issues. The Federal Reserve also participates in the Basel committee's Task Force on Accounting Issues and its Transparency Group and represents the Basel com-

mittee at international meetings on the issues addressed by these groups. In particular, the Federal Reserve in 2000 represented the Basel committee in meetings of the unit of the International Accounting Standards Committee (IASC) that works on improved accounting guidance for financial instruments. This effort resulted in four proposals and final implementation guidance for IAS 39, the IASC's comprehensive accounting standard for financial instruments.

During 2000 the Federal Reserve also contributed to several policy papers on control, accounting, and disclosure that were issued by the Basel committee:

- *Internal Audit in Banking Organizations and the Relationship of the Supervisory Authorities with Internal and External Auditors* (July)

The paper sets out objectives and principles for an effective bank internal audit function, the role of internal audit, and the banking supervisors' view on ways to strengthen the relationship between banking supervisors and internal and external auditors.

- *Best Practices for Credit Risk Disclosure* (September)

Encourages banks to provide market participants and the public with the information they need to make meaningful assessments of bank credit risk profiles.

- *Report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards* (April)

The report's recipients had asked the Basel committee to review the standards of the IASC that have a significant effect on banks. Supportive, overall, of the IASC's standards, the report also summarizes supervisory concerns raised by certain

standards and recommends improvements based, in part, on the Basel committee's efforts to enhance bank transparency.

### Gramm–Leach–Bliley Act

The Gramm–Leach–Bliley (GLB) Act repeals those provisions of the Glass–Steagall Act and the Bank Holding Company Act that restrict the ability of bank holding companies (BHCs) to affiliate with securities firms and insurance companies. The provisions of the GLB Act—and the Federal Reserve's final rule, published in December 2000—establish conditions that a BHC or a foreign bank must meet to be deemed a financial holding company (FHC) and to engage in expanded activities.

In addition to controlling depository institutions, permissible activities for FHCs include conducting securities underwriting and dealing, serving as an insurance agent and insurance underwriter, acting as a futures commission merchant, and engaging in merchant banking. Permissible activities also include those that the Board and the Secretary of the Treasury jointly determine to be financial in nature or incidental to financial activities; and they include those that the Federal Reserve determines are complementary to a financial activity and do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Under the GLB Act, the Federal Reserve has supervisory oversight authority and responsibility for BHCs, including BHCs that operate as FHCs. The statute streamlines the Federal Reserve's supervision for all BHCs and sets forth parameters for the relationship between the Federal Reserve and other regulators. The statute differentiates

between the Federal Reserve's relations with regulators of depository institutions and functional regulators, which include those for insurance, securities, and commodities.

### *Umbrella Supervision of Financial Holding Companies*

On August 15 the Federal Reserve issued a framework for its supervision of FHCs. The framework covers the purpose and scope of the Federal Reserve's supervision and the requirements of the GLB Act for working with the primary and functional regulators.

The Federal Reserve's role as the supervisor of FHCs is to concentrate on a consolidated or group-wide analysis of each organization to ensure that the holding company does not threaten the viability of its depository institution subsidiaries. Umbrella supervision should create minimal, if any, noticeable change in the well-established relationships between the Federal Reserve as BHC (including FHC) supervisor and bank and thrift supervisors (federal and state). The Federal Reserve's relationships with functional regulators will, in practice, depend upon the extent to which an FHC is engaged in functionally regulated activities and also will be influenced by already established arrangements for coordination and information sharing.

### *Merchant Banking Activities*

On March 17 the Federal Reserve and the U.S. Department of the Treasury jointly issued for comment an interim rule implementing the merchant banking provisions of the GLB Act.<sup>8</sup> At

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8. In merchant banking, a financial institution invests in a corporation, taking up to a full ownership position and usually a seat on the board of directors, but does not engage in its day-to-day management.

the same time, the Federal Reserve also released a proposal to set minimum regulatory capital standards for the equity investments of BHCs and FHCs. The proposal, which was subject to public comment, applied to merchant banking activities as well as other equity investments made under authorization granted outside the GLB Act.<sup>9</sup>

On June 22 the Federal Reserve issued supervisory guidance on sound risk management practices for equity investments and merchant banking activities. To improve its allocation of supervisory resources, the Federal Reserve in 2000 established a “competency center” of examiners specializing in equity investments and merchant banking.

### *Information Security Standards*

Under section 501(b) of the GLB Act, the federal banking agencies are required to issue information security standards. In December the agencies issued *Interagency Guidelines Establishing Standards for Safeguarding Customer Information* after soliciting public comment on a June 2000 proposal. The Board’s guidelines are effective July 1, 2001, and require banks and holding companies to establish a written information security program and to control the risk of unauthorized access or other threats to the security and confidentiality of customer information.

### *Efforts to Enhance Transparency*

The Federal Reserve has long supported sound accounting policies and meaningful public disclosure by banking and financial organizations to improve mar-

ket discipline and foster stable financial markets. Effective market discipline can provide an important complement to bank supervision and regulation. The more informative the information released by financial institutions, the better will be the evaluation of counterparty risks that market participants can make and the better will be their adjustments to the availability and pricing of funds. Thus, transparency can promote efficiency in financial markets and sound practices by banks. The Federal Reserve also seeks to strengthen audit and control standards for banks; the quality of management information and financial reporting is dramatically affected by internal control systems, including internal audit programs, and external audit programs.

To advance these objectives, the Federal Reserve works with other regulators, the accounting profession, and a wide variety of market participants, both domestically and (see above) internationally.

### *Interagency Guidance on the Allowance for Loan Losses*

During 2000 the Federal Reserve, the SEC, and the other federal banking agencies continued to develop joint guidance regarding the allowance for loan losses. In September the Federal Reserve and the other federal banking agencies, under the auspices of the FFIEC, issued for public comment a proposed policy statement on appropriate methodologies and documentation for the allowance for loan and lease losses. The proposal reflects the agencies’ view that the boards of directors and management of financial institutions are ultimately responsible for these matters. Institutions must have controls in place to maintain an appropriate allowance level and to ensure that

9. The interim rule was made final as of February 2, 2001. The capital proposal was substantially revised and repropounded on February 14, 2001, with comment due by April 16, 2001.

the allowance process incorporates current judgments about the credit quality of the loan portfolio in a manner that is thorough, disciplined, and consistently applied.

The proposal also emphasizes that institutions should maintain and support the allowance with documentation that is consistent with their stated policies and procedures and appropriately tailored to the complexity of their loan portfolio. The SEC is planning to provide parallel guidance on this topic in a separate document.

#### *Private-Sector Working Group on Public Disclosure*

In April 2000 the Federal Reserve, with the participation of the OCC and the SEC, established the Working Group on Public Disclosure. The group was made up of senior executives from major domestic and foreign banking organizations and securities firms and was led by Walter Shipley, retired chairman of Chase Manhattan Bank. In January 2001 the working group released a report recommending enhanced and more frequent public disclosure of financial information by banking and securities firms. Private-sector efforts, such as those of the working group, and official regulatory initiatives can help foster a consensus and advance thinking on what constitutes sound or best practice regarding public disclosure.

#### **Bank Holding Company Regulatory Financial Reports**

The Federal Reserve requires periodic regulatory financial reports from U.S. bank holding companies. These reports, the FR Y-9 series and the FR Y-11 series, provide information essential to the supervision of the organizations and to the formulation of regulations

and supervisory policies. The Federal Reserve also uses the reports to respond to requests from the Congress and the public for information on bank holding companies and their nonbank subsidiaries.

The FR Y-9 series of reports provides standardized financial statements for the consolidated bank holding company and its parent. These reports are used to detect emerging financial problems, review performance and conduct pre-inspection analysis, monitor and evaluate risk profiles and capital adequacy, evaluate proposals for bank holding company mergers and acquisitions, and analyze the holding company's overall financial condition.

The FR Y-11 series of reports aids the Federal Reserve in determining the condition of bank holding companies that are engaged in nonbanking activities and in monitoring the volume, nature, and condition of their nonbanking subsidiaries.

The Federal Reserve made no revisions to the FR Y-9 and FR Y-11 series of reports for 2000 to allow the industry to focus on readying its computer systems for the century date change. The Federal Reserve did, however, implement an ad hoc supplement to the FR Y-9C and FR Y-9SP reports during the first quarter of 2000. The supplement, the FR Y-9CS, is being used to collect summary financial data from financial holding companies that are engaging in new activities permissible under the Gramm-Leach-Bliley Act. In addition, the Federal Reserve completely revised the FR Y-8 report, which governs certain transactions between an insured depository institution and its affiliates.

In light of the Gramm-Leach-Bliley Act and increased activity by banking organizations in merchant banking and equity investment in nonfinancial com-



panies, the Federal Reserve announced work on the FR Y-12 report, which will track these activities. The report is scheduled to be released for comment in mid-2001.

### Federal Financial Institutions Examination Council

During the year, the Federal Financial Institutions Examination Council (FFIEC) issued major revisions to the Call Report and handled two issues regarding retail credit.<sup>10</sup>

#### *Bank Call Reports*

As the federal supervisor of state member banks, the Federal Reserve, acting in concert with the other federal banking agencies through the FFIEC, requires banks to submit quarterly Reports of Condition and Income (the Call Report). The Call Report is one of the primary sources of data for the supervision and regulation of banks and for the ongoing assessment of the overall soundness of the nation's financial structure. Call Report data, which also serve as benchmarks for the financial information required in many other Federal Reserve regulatory financial reports, are widely used by state and local governments, state banking supervisors, the banking industry, securities analysts, and the academic community. For the 2000 reporting period, the FFIEC deferred the implementation of changes to the Call Report and other supervisory reports to allow banks to focus their resources on Year 2000 readiness.

On November 2, 2000, after consideration of public comments, the FFIEC announced significant revisions designed to make the 2001 Call Report

more relevant to the evolving financial services environment; the new Call Report will also complement the agencies' emphasis on risk-focused supervision. The modifications include the collection of new data on asset securitizations and a new trust activities schedule. The revisions also address certain aspects of section 307 of the Riegle Community Development and Regulatory Improvement Act of 1994 by improving the uniformity of Call Report forms and instructions and by eliminating certain reporting requirements that are not warranted by safety and soundness or other public policy purposes.

#### *Reporting to Credit Bureaus*

On January 18 the federal banking agencies issued an advisory letter regarding the practice at some financial institutions of not reporting customer credit lines or high credit balances to credit bureaus. The agencies advised financial institutions that if they do not modify their management processes to compensate for data omitted in credit bureau reports, they could inadvertently expose themselves to increased credit risk.

#### *Uniform Retail Credit Classification and Account Management Policy*

On June 12 the FFIEC issued a revised Uniform Retail Credit Classification and Account Management Policy, which became effective on December 31, 2000. Among other things, the revised policy clarifies provisions regarding extensions, deferrals, renewals, and rewrites of closed-end loans and the re-aging of open-end accounts. The revisions also include additional examiner guidance in the classification of retail portfolios and modifications to the treatment of specific categories of loans, such as loans with collateral, loans secured

10. For the membership of the FFIEC, see note 4.

by residential real estate, and loans in bankruptcy.

### **Supervisory Information Technology**

The Supervisory Information Technology (SIT) function within the Board's Division of Banking Supervision and Regulation facilitates management of information technology within the Federal Reserve's supervision function. Its goals are to ensure that

- IT initiatives support a broad range of supervisory activities without duplication or overlap
- The underlying IT architecture fully supports those initiatives
- The supervision function's use of technology takes advantage of the systems and expertise available more broadly within the Federal Reserve System.

SIT works through assigned staff at the Board of Governors and the Reserve Banks and through a committee structure that ensures that key staff members throughout the Federal Reserve System participate in identifying requirements and setting priorities for IT initiatives. SIT also houses the management of the National Information Center (NIC), a comprehensive repository for vital supervision information.

### **SIT Activities**

In 2000 SIT developed an operating plan for the ongoing approval and reassessment of IT projects. In an effort to support a broad range of supervisory activities throughout the System without duplication or overlap, SIT is also assessing the costs and benefits of possible centralization of System products, projects, and support. It also is pre-

paring a project manager's handbook, which draws on the best practices in private industry and the government, as part of its project management training for Reserve Bank and Board staff.

### **Enhancements to the National Information Center**

The National Information Center (NIC) is the Federal Reserve's comprehensive repository for supervisory, financial, and banking structure data. NIC also includes the National Examination Data (NED) system, software that provides supervisory personnel and state banking authorities with access to NIC data. A new version of NED is planned for mid-2001.

The proposed new reporting forms for collecting structure data for NIC, the Y-10 and Y-10f, are scheduled for release on June 1, 2001.

The process of transferring structure and financial data and supervisory information among the FFIEC agencies was automated in 2000 to cover the Federal Reserve, the FDIC, and the OCC. In 2001 this process will be expanded to include the OTS.

In 2000, NIC was enhanced with a repository for supervisory documents including examination and inspection documents, enforcement-event documents, and other products associated with a region of the United States or a Federal Reserve District (for domestic bank holding companies), a country (for foreign banking organizations), or risk profiles. Development of the repository for possible other uses is ongoing.

### **Staff Training**

The System Staff Development Program trains staff members with supervisory and regulatory responsibilities at the Reserve Banks, at the Board of Gover-

## Number of Sessions of Training Programs for Banking Supervision and Regulation, 2000

Program	Total	Regional
<i>Schools or seminars conducted by the Federal Reserve</i>		
<i>Core schools</i>		
Banking and supervision elements .....	7	5
Operations and analysis .....	6	5
Bank management .....	4	1
Report writing .....	17	17
Management skills .....	11	9
Conducting meetings with management .....	16	16
<i>Other schools</i>		
Loan analysis .....	7	5
Examination management .....	3	...
Real estate lending seminar .....	4	2
Specialized lending seminar .....	3	2
Senior forum for current banking and regulatory issues .....	4	4
Banking applications .....	1	...
Basic entry-level trust .....	2	...
Advanced trust .....	1	...
Commercial essentials for consumer affairs .....	1	1
Consumer compliance examinations I .....	2	...
Consumer compliance examinations II .....	2	1
CRA examination techniques .....	3	2
Fair lending examination techniques .....	3	2
Foreign banking organizations .....	5	3
Information systems continuing education .....	2	...
Capital markets seminars .....	10	6
Technology risk integration .....	5	5
Leadership dynamics .....	5	4
GLBA case studies .....	2	...
Seminar for senior supervisors of foreign central banks <sup>1</sup> .....	1	...
<i>Other agencies conducting courses<sup>2</sup></i>		
Federal Financial Institutions Examination Council .....	43	4
The Options Institute .....	1	1

1. Conducted jointly with the World Bank.

... Not applicable.

2. Open to Federal Reserve employees.

nors, and at state banking departments. The program's goals are in part to provide a higher degree of cross-training in the agencies. Students from foreign supervisory authorities attend the training sessions on a space-available basis. The program provides training at the basic, intermediate, and advanced levels for the four disciplines of bank supervision: bank examinations, bank holding company inspections, surveillance and monitoring, and applications analysis. Classes are conducted in Washington, D.C., as well as at other locations and are sometimes held jointly with other regulators.

The Federal Reserve System also participates in training offered by the

FFIEC and by certain other regulatory agencies. The System's involvement includes developing and implementing basic and advanced training in various emerging issues as well as in specialized areas such as trust activities, international banking, information technology, municipal securities dealing, capital markets, payment systems risk, white collar crime, and real estate lending. In addition, the System co-hosts the World Bank Seminar for students from developing countries.

The Federal Reserve conducts a variety of schools and seminars, and staff members participate in courses offered by or cosponsored with other agencies, as shown in the accompanying table.

## Student Examination Results, First Track, 2000

Result	Core proficiency	Specialty			
		Safety and soundness	Consumer affairs	Trust	Information technology
Passed .....	74	30	15	2	1
Failed .....	15	9	8	1	0
<b>Total .....</b>	<b>89</b>	<b>39</b>	<b>23</b>	<b>3</b>	<b>1</b>

Note. These examinations are for examiners hired before February 28, 1998.

In 2000 the Federal Reserve trained 2,890 students in System schools, 754 in schools sponsored by the FFIEC, and 32 in other schools, for a total of 3,676, including 314 representatives from foreign central banks. The number of training days in 2000 were 19,318.

The Federal Reserve System also gave scholarship assistance to the states for training their examiners in Federal Reserve and FFIEC schools. Through this program 449 state examiners were trained—286 in Federal Reserve courses, 160 in FFIEC programs, and 3 in other courses.

In 2000 the System completed the work begun in 1997 to revise the core training that leads to the commissioning of assistant examiners. The project was undertaken to ensure that course materials provide examiners with a greater understanding of risk-focused examination concepts, the components of sound internal controls, the importance of

management information systems, the concept of risk as it applies to banking, and the key supervisory issues related to integrated supervision.

A staff member seeking an examiner's commission follows one of two training tracks: The first track, for staff members hired before February 28, 1998, involves a "core proficiency examination" as well as a specialty examination of the student's choice—safety and soundness, consumer affairs, or information technology. Examiners on this track should complete their commissioning requirements by December 31, 2001. In 2000, 74 examiners passed the core proficiency examination (see table).

The second track, for examiners hired after February 27, 1998, involves a "first proficiency examination" as well as a "second proficiency examination" in one of the three specialty areas. In 2000, 159 examiners passed the first

## Student Examination Results, Second Track, 2000

Result	First proficiency	Second proficiency			
		Safety and soundness	Consumer affairs	Trust	Information technology
Passed .....	159	11	14	1	0
Failed .....	1	1	2	0	0
<b>Total .....</b>	<b>160</b>	<b>12</b>	<b>16</b>	<b>1</b>	<b>0</b>

Note. These examinations are for examiners hired after February 27, 1998.

proficiency examination (see table). In the second proficiency examination, 11 examiners passed the safety and soundness examination, and 14 examiners passed the consumer affairs examination.

During 2000 the Federal Reserve eliminated the separate commission for trust examiners because of the small number of examiners choosing that specialty as well as the need for strong general training in banking supervision for all examiners, regardless of their ultimate specialty.

### **Regulation of the U.S. Banking Structure**

The Board of Governors administers the Bank Holding Company Act, the Bank Merger Act, the Change in Bank Control Act, and the International Banking Act in relation to bank holding companies, financial holding companies, member banks, and foreign banking organizations. In doing so, the Federal Reserve acts on a variety of proposals that directly or indirectly affect the structure of U.S. banking at the local, regional, and national levels; the international operations of domestic banking organizations; and the U.S. banking operations of foreign banks.

#### **Bank Holding Company Act**

Under the Bank Holding Company Act, a corporation or similar organization must obtain the Federal Reserve's approval before becoming a bank holding company through the acquisition of one or more banks in the United States. Any holding company must receive Federal Reserve approval before acquiring or establishing additional banks. The act also identifies other activities permissible for a bank holding company; depending on the circumstances, these activities may or may not require Fed-

eral Reserve approval in advance of their commencement.

The Board has previously identified those nonbank activities that are closely related to banking and therefore generally permissible for bank holding companies. Since 1996 the act has permitted well-run bank holding companies that satisfy certain criteria to commence some of those nonbank activities on a *de novo* basis without first obtaining Federal Reserve approval; and since 1996 the act also has provided an expedited prior-notice procedure for the remaining permissible nonbank activities and for small bank and nonbank acquisitions. Other recent amendments to the act are discussed in the next section.

When reviewing an application or notice that requires advance approval, the Federal Reserve must consider the financial and managerial resources of the applicant, the future prospects of both the applicant and the firm to be acquired, the convenience and needs of the community to be served, the potential public benefits, the competitive effects of the proposal, and the applicant's ability to make available to the Board information deemed necessary to ensure compliance with applicable law. In the case of a foreign banking organization seeking to acquire control of a U.S. bank, the Federal Reserve also considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. Data on decisions regarding domestic and international applications in 2000 are shown in the accompanying table.

#### **Recent Amendments to the Bank Holding Company Act**

The Bank Holding Company Act (BHC Act) was significantly amended on

## Decisions by the Federal Reserve on Domestic and International Applications, 2000

Proposal	Direct action by the Board of Governors			Action under authority delegated by the Board of Governors					Total
				Director of the Division of Banking Supervision and Regulation		Office of the Secretary	Federal Reserve Banks		
	Approved	Denied	Permitted	Approved	Denied	Approved	Approved	Permitted	
Formation of bank holding company .....	18	0	0	0	0	1	165	77	261
Merger of bank holding company .....	7	0	0	0	0	9	44	24	84
Acquisition or retention of bank .....	18	0	0	0	0	6	128	55	207
Acquisition of nonbank .....	0	1	50	0	0	47	0	203	301
Merger of bank .....	6	0	0	0	0	11	131	0	148
Change in control ....	0	0	0	0	0	1	0	133	134
Establishment of a branch, agency, or representative office by a foreign bank ....	18	0	1	0	0	0	13	0	32
Other .....	243	0	29	23	0	129	1,475	166	2,065
<b>Total .....</b>	<b>310</b>	<b>1</b>	<b>80</b>	<b>23</b>	<b>0</b>	<b>204</b>	<b>1,956</b>	<b>658</b>	<b>3,232</b>

March 11, 2000, when certain provisions of the Gramm–Leach–Bliley Act became effective. Title I of the GLB Act repealed provisions of the BHC Act and of the Glass–Steagall Act that had previously restricted the ability of bank holding companies to engage in certain nonbanking activities. The GLB Act authorized the creation of a special type of bank holding company called a financial holding company. The law also made major changes in the list of activities in which financial organizations are permitted to engage, allowing the affiliation of banks with securities firms and insurance companies and authorizing certain merchant banking activities.

Bank holding companies that do not meet the eligibility criteria to become a financial holding company may engage only in those activities that the Board had previously determined to be closely

related to banking under section 4(c)(8) of the BHC Act. A bank holding company that is not a financial holding company remains subject to the restrictions that were in effect before the GLB Act's March 2000 amendments to the BHC Act.

Financial holding companies do not have to obtain the Board's advance approval to engage in or acquire a company engaged in new financial activities. Instead, the financial holding company must notify the Board within thirty days after commencing a new activity or acquiring a company engaged in a new activity. A financial holding company also may engage in certain other activities that have been determined to be financial in nature or incidental to a financial activity or that are determined to be complementary to a financial activity.

A bank holding company must file a written declaration with the Federal Reserve System to become a financial holding company. Such declarations are usually acted upon by a Reserve Bank or senior Board official under authority delegated by the Board, or by the Board itself. In 2000, 463 domestic financial holding company declarations and 21 foreign bank declarations were approved.

### Bank Merger Act

The Bank Merger Act requires that all proposed mergers of insured depository institutions be acted on by the appropriate federal banking agency. If the institution surviving the merger is a state member bank, the Federal Reserve has primary jurisdiction. Before acting on a proposed merger, the Federal Reserve considers the financial and managerial resources of the applicant, the future prospects of the existing and combined institutions, the convenience and needs of the community to be served, and the competitive effects of the proposal. It also considers the views of certain other agencies regarding the competitive factors involved in the transaction. During 2000 the Federal Reserve approved 148 merger applications.

When the FDIC, the OCC, or the OTS has jurisdiction over a merger, the Federal Reserve is asked to comment on the competitive factors to ensure comparable enforcement of the antitrust provisions of the Bank Merger Act. The Federal Reserve and those agencies have adopted standard terminology for assessing competitive factors in merger cases to ensure consistency in administering the act. The Federal Reserve submitted 625 reports on competitive factors to the other federal banking agencies in 2000.

### Change in Bank Control Act

The Change in Bank Control Act requires persons (including certain companies) seeking control of a U.S. bank or bank holding company to obtain approval from the appropriate federal banking agency before completing the transaction. The Federal Reserve is responsible for reviewing changes in the control of state member banks and bank holding companies. In doing so, the Federal Reserve reviews the financial position, competence, experience, and integrity of the acquiring person; considers the effect of the proposal on the financial condition of the bank or bank holding company to be acquired; determines the effect of the proposal on competition in any relevant market; assesses the completeness of information submitted by the acquiring person; and considers whether the proposal would have an adverse effect on the federal deposit insurance funds. As part of this process, the Federal Reserve may contact other regulatory or law enforcement agencies for information about each acquiring person.

The appropriate federal banking agencies are required to publish notice of each proposed change in control and to invite public comment, particularly from persons located in the markets served by the institution to be acquired.

In 2000 the Federal Reserve approved 134 proposed changes in control of state member banks and bank holding companies.

### International Banking Act

The International Banking Act, as amended by the Foreign Bank Supervision Enhancement Act of 1991, requires foreign banks to obtain Federal Reserve approval before establishing branches, agencies, commercial lending company

subsidiaries, or representative offices in the United States.

In reviewing proposals, the Federal Reserve generally considers whether the foreign bank is subject to comprehensive supervision or regulation on a consolidated basis by its home country supervisor. The Federal Reserve may also consider whether the home country supervisor has consented to the establishment of the U.S. office; the financial condition and resources of the foreign bank and its existing U.S. operations; the managerial resources of the foreign bank; whether the home country supervisor shares information regarding the operations of the foreign bank with other supervisory authorities; whether the foreign bank has provided adequate assurances that information concerning its operations and activities will be made available to the Board, if deemed necessary to determine and enforce compliance with applicable law; and the record of the foreign bank with respect to compliance with U.S. law.

In 2000 the Federal Reserve approved thirty-two applications by foreign banks to establish branches, agencies, and representative offices in the United States.

#### Overseas Investments by U.S. Banking Organizations

With the authorization of the Federal Reserve, U.S. banking organizations may engage in a broad range of activities overseas. Most foreign investments may be made under general consent procedures that involve only an after-the-fact notification to the Board; significant investments must be reviewed in advance by the Board. Excluding proposals relating to recent large domestic mergers, the Board in 2000 approved forty-one proposals for significant overseas investments by U.S. banking organizations.

The Federal Reserve also has authority to act on proposals involving Edge Act and agreement corporations, which are established by banking organizations to provide a means of engaging in international business. In 2000 the Federal Reserve approved two applications to establish a new Edge Act corporation and three applications to establish a new agreement corporation.

#### Applications by Member Banks

State member banks must obtain Federal Reserve approval to establish domestic branches, and member banks (including national banks) must obtain Federal Reserve approval to establish foreign branches. When reviewing proposals for domestic branches, the Federal Reserve considers the scope and character of the proposed banking activities to be conducted. When reviewing proposals for foreign branches, the Federal Reserve considers, among other things, the condition of the bank and the bank's experience in international banking. Once a member bank has received authority to open a branch in a particular foreign country, the member bank may open additional branches in that country without prior approval from the Federal Reserve. Excluding proposals relating to recent large domestic mergers, the Federal Reserve in 2000 acted on new and merger-related branch proposals for 1,697 domestic branches and granted advance approval for the establishment of 14 foreign branches.

#### Stock Repurchases by Bank Holding Companies

A bank holding company may repurchase its own shares from its shareholders. When the company borrows money to buy the shares, the trans-



action increases the company's debt and decreases its equity. The Federal Reserve may object to stock repurchases by holding companies that fail to meet certain standards, including the Board's capital guidelines. In 2000 the Federal Reserve reviewed thirty-three proposed stock repurchases by bank holding companies, all of which were approved by a Reserve Bank under delegated authority.

### Public Notice of Federal Reserve Decisions

Most decisions by the Federal Reserve that involve a bank holding company, a bank merger, a change in control, or the establishment of a new U.S. banking presence by a foreign bank are effected by an order or an announcement. Orders state the decision, the essential facts of the application or notice, and the basis for the decision; announcements state only the decision. All orders and announcements are made public immediately; they are subsequently reported in the Board's weekly H.2 statistical release and in the monthly *Federal Reserve Bulletin*. The H.2 release also contains announcements of applications and notices received by the Federal Reserve but not yet acted on. For each pending application and notice, the related H.2A contains the deadline for comments. The Board's public web site ([www.federalreserve.gov](http://www.federalreserve.gov)) continued to be expanded in 2000 to include more information relevant to the applications process.

### Timely Processing of Applications

The Federal Reserve maintains internal target dates and procedures for the processing of applications. The setting of target dates promotes efficiency at the Board and the Reserve Banks and reduces the burden on applicants. The

time period established for final action ranges from twelve days to sixty days, depending on the type of application or notice. In 2000, 89 percent of decisions were made within the established time period.<sup>11</sup>

### Delegation of Applications

Historically, the Board of Governors has delegated certain regulatory functions, including the authority to approve, but not to deny, certain types of applications, to the Reserve Banks, to the Director of the Board's Division of Banking Supervision and Regulation, and to the Secretary of the Board. In 2000, 88 percent of the applications processed were handled under delegated authority.

### Enforcement of Other Laws and Regulations

The Board's enforcement responsibilities also cover financial disclosures of state member banks; securities credit; and efforts, under the Bank Secrecy Act, to counter money laundering.

### Financial Disclosures of State Member Banks

State member banks that issue securities registered under the Securities Exchange Act of 1934 must disclose certain information of interest to investors, including annual and quarterly financial reports and proxy statements. By statute, the Board's financial disclosure rules must be substantially similar to those of the Securities and Exchange Commission. At the end of 2000, twenty-three state

11. If the data were adjusted for multiple related applications filed in connection with several larger merger proposals, the percentage would be 94 percent.

member banks, most of them small or medium sized, were registered with the Board under the Securities Exchange Act.

### Securities Credit Regulations

Under the Securities Exchange Act of 1934, the Board is responsible for regulating credit in certain transactions involving the purchase or carrying of securities. The Board's Regulation T limits the amount of credit that may be provided by securities brokers and dealers when the credit is used to trade debt and equity securities. The Board's Regulation U limits the amount of credit that may be provided by lenders other than brokers and dealers when the credit is used to purchase or carry publicly held equity securities if the loan is secured by those or other publicly held equity securities. The Board's Regulation X applies these credit limitations, or margin requirements, to certain borrowers and to certain credit extensions, such as credit obtained from foreign lenders by U.S. citizens.

Several regulatory agencies enforce the Board's securities credit regulations. The SEC, the National Association of Securities Dealers, and the national securities exchanges examine brokers and dealers for compliance with Regulation T. The federal banking agencies examine banks under their respective jurisdictions for compliance with Regulation U. The Farm Credit Administration, the National Credit Union Administration, and the Office of Thrift Supervision examine lenders under their respective jurisdictions for compliance with Regulation U; the Federal Reserve examines other Regulation U lenders.

Since 1990 the Board has published a list of foreign stocks that are eligible for margin treatment at broker-dealers on the same basis as domestic margin

securities. In 2000 the foreign list was revised in March and September (see [www.federalreserve.gov/boarddocs/foreignmargin](http://www.federalreserve.gov/boarddocs/foreignmargin)).

### Deterring Money Laundering

The Department of the Treasury's regulation (31 CFR 103) implementing the Currency and Foreign Transactions Reporting Act (the Bank Secrecy Act), requires banks and other types of financial institutions to file certain reports and maintain certain records. The act is a primary tool in the fight against money laundering, and its requirements inhibit money laundering by creating a paper trail of financial transactions that helps law enforcement and regulators identify and trace the proceeds of illegal activity.

The Federal Reserve monitors compliance with the Bank Secrecy Act and related Federal Reserve regulations (in the Board's Regulation H) by the banking organizations under its supervision. Pursuant to section 208.62 of Regulation H, banking organizations are required to report suspicious activity related to possible violations of federal law, including money laundering and other financial crimes. In addition, pursuant to section 208.63 of Regulation H, each banking organization supervised by the Federal Reserve must develop a written program for compliance with the Bank Secrecy Act that is formally approved by the institution's board of directors. The compliance program must (1) establish a system of internal controls to ensure compliance with the act, (2) provide for independent compliance testing, (3) identify individuals responsible for coordinating and monitoring day-to-day compliance, and (4) provide training for appropriate personnel.

In 2000 the Federal Reserve continued to provide expertise and guidance to the Bank Secrecy Act Advisory Group,

a committee of government and industry representatives that the Congress established at the Department of the Treasury to seek measures to reduce unnecessary burdens created by the act and to increase the utility of data gathered under the act to aid regulators and law enforcement. As part of that effort, an interagency group led by the Federal Reserve issued a revised Suspicious Activity Report in June 2000.

In a related project during 2000, the Federal Reserve chaired a working group on improving the reporting of suspicious activity; the group consisted of federal law enforcement and regulatory personnel as well as financial services representatives. The result was a mechanism for providing feedback to financial institutions on suspicious activity reporting (SAR). A document released by the group in October, *The SAR Activity Review: Trends, Tips, and Issues*, presents SAR statistics, patterns and trends of suspicious activity, and tips and guidance for financial institutions on the preparation and filing of the SAR form.

In addition, the Federal Reserve participates in the effort to deter money laundering announced by the Department of Treasury in the "National Money Laundering Strategy for 2000–2001." For that program, the Federal Reserve developed guidance on enhanced scrutiny for transactions that

may involve the proceeds of foreign official corruption.

Through the Special Investigations Section of the Division of Banking Supervision and Regulation, the Federal Reserve has assisted in the investigation of money laundering activities involving a number of foreign banking organizations. The section has also provided anti-money-laundering training to staff members at Reserve Banks, to the domestic banking sector through trade association conferences and seminars, and to representatives of law enforcement agencies.

Internationally, the section has assisted the State Department by providing anti-money-laundering training and technical assistance to countries in Asia; in eastern Europe, including the newly independent states; in South and Central America; and in the Caribbean. Federal Reserve staff members have also participated in numerous multilateral anti-money-laundering initiatives sponsored by the Group of 7, the Financial Action Task Force, and the Asia Pacific Working Group on Money Laundering.

### Loans to Executive Officers

Under section 22(g) of the Federal Reserve Act, a state member bank must include in its quarterly Call Report information on all extensions of credit

Loans by State Member Banks to their Executive Officers, 1999 and 2000

Period	Number	Amount (dollars)	Range of interest rates charged (percent)
<i>1999</i>			
October 1–December 31 .....	695	82,050,000	3.0–18.0
<i>2000</i>			
January 1–March 31 .....	696	53,011,000	2.0–21.0
April 1–June 30 .....	755	52,119,000	6.0–20.8
July 1–September 30 .....	739	62,815,000	3.9–20.8

SOURCE. Call Reports.

by the bank to its executive officers since the date of the preceding report. The accompanying table summarizes this information.

### **Federal Reserve Membership**

At the end of 2000, 3,164 banks were members of the Federal Reserve System and were operating 47,722 offices. At year-end, member banks accounted for about 38 percent of all commercial banks in the United States and approximately 70 percent of all commercial banking offices. ■

## *Federal Reserve Banks*

The Federal Reserve Banks devoted significant attention in 2000 to standardizing hardware and software platforms for check processing and adjustments, instituting check imaging and a check image archive, and developing an Internet delivery platform for check services. This chapter describes those efforts, known collectively as “check modernization,” as well as other activities affecting the Reserve Banks.

### **Check Modernization Project**

The Federal Reserve Banks began a five-year check modernization initiative to install uniform software and hardware for check processing, imaging, and adjustments in forty-five Reserve Bank offices, and to provide web access to check services. The project’s operating expenses of approximately \$250 million are expected to be recovered, over the long run, by enabling more efficient operations and additional service offerings to depository institutions.

The check modernization project is one of the most significant operational efforts the Federal Reserve Banks have ever undertaken. It will directly affect about 5,500 Federal Reserve employees and 8,000 depository institutions and will substantially alter the infrastructure of the Reserve Banks’ check service. The schedule calls for implementing new technology and retraining the entire check services staff in less than four years.

The check modernization effort consists of four interrelated projects. A central management team under the Reserve Banks’ Retail Payments Office is lead-

ing the entire initiative, with oversight by the Board of Governors. Teams consisting of staff members from several Reserve Banks oversee each of the four projects.

The largest of the four projects, at 80 percent of the budget, is check standardization, which will provide common check-processing software at all forty-five processing sites (see box). Currently, check-processing services throughout the System run on two different software platforms, and each District has further customized its software to offer additional services. These variations reduce the ability of the Reserve Banks to provide uniform services nationwide at a time when depository institutions increasingly expect uniform services across Districts, especially as banks consolidate across state lines. After completing the check standardization project, the Reserve Banks will use a new, centrally managed check-processing software platform that will enable the Reserve Banks to offer a uniform set of services nationwide and to add new uniform services more efficiently.

The second project, enterprise-wide adjustments, will result in a uniform, nationally linked platform for researching and resolving bank adjustment requests. Such requests arise because of exceptions discovered through bank reconciliation processes—such as missing or extra checks or checks processed for the wrong dollar amount. The new system will streamline the adjustments process and will allow backlogged adjustment cases in any Reserve Bank office to be processed at any other Reserve Bank office.

## Check Standardization

The Federal Reserve Banks process checks using multiple hardware and software platforms. Currently, seven Reserve Banks use a Unisys check-processing platform at twenty-six sites, and five Reserve Banks use an IBM check-processing platform at nineteen sites. As check-processing technology has advanced, vendors have begun to discontinue support for older equipment and software that some of the Reserve Banks use. At the same time, as the market has changed, depository institutions have demanded greater uniformity in Reserve Bank products and services. The Reserve Banks' current check-processing infrastructure, however, hampers their ability to implement new technologies rapidly and roll out new national products to meet customer demand. In addition, the historical

independence of each Reserve Bank has resulted in a large number of software applications, each with District-specific variations, which make providing uniform services even more difficult. These many challenges make the effort to implement a standard check-processing platform the most significant component of the check modernization initiative.

The check standardization project will replace the current network of twelve relatively independent check-processing systems with a standard platform in all twelve Banks. The key to accomplishing this goal lies in the check-processing software. The core components of a check-processing system are check sorters, which electronically capture data from checks as the checks are physically sorted, and software,

The third project, the image services system, will integrate current image production from many nonstandard hardware and software platforms into a consistent production environment for the capture and archiving of check images. Banks use check images for a variety of applications, including creating image statements, researching exceptions, and providing account holders access to their check images via CD-ROM or the Internet. When completed, this project will allow Reserve Banks to offer depository institutions check images and image retrieval services in a standard format nationwide. This project is also designed to facilitate electronic check presentment by providing access to images of checks and reducing reliance on paper checks.

The fourth project, electronic access and delivery, will convert the current DOS-based FedLine service to web-based applications. FedLine provides

banks a secure connection to Reserve Bank computer networks for services such as wire transfers, automated clearinghouse transactions, and access to electronic check presentment files and account balance information. With the new platform, banks will have the option of using "FedLine for the Web," a collection of services providing electronic access to and delivery of check services from almost any location, and Reserve Banks will be able to provide new services over the Internet.

The Reserve Banks' Retail Payments Office manages this multiyear initiative for the System. In addition, each of the Reserve Banks has appointed a District transition manager, who is responsible for coordinating interdependencies among the four projects within that District. This structure is designed to provide consistent communication of key issues and to mitigate some of the risks in managing such a large initiative.

which drives the sorters and manages the captured data. The software is the primary driver of a platform's functionality and its ability to interface with other applications. Although the Reserve Banks currently use only two basic types of check-processing system, each Reserve Bank uses a variety of software packages to enhance the functionality of these systems.

In the check standardization project, standard check-processing software will be installed at all forty-five processing sites. The check-processing system used at these sites will be centrally managed and will support a uniform set of products nationwide. Once they have converted to the standard platform, the Reserve Banks will be able to operate multiple types of check-sorting hardware using the same software.

The check standardization project is the most complex of the four check modern-

ization projects and is expected to take nearly four years to complete, with the last site converting to the standard platform in 2003. Capital outlays for the project are expected to total approximately \$60 million, and expenses are expected to total slightly more than \$200 million through the end of the project in 2004. Concurrent with the project, the Reserve Banks will be required to upgrade many of their high-speed check sorters as vendors discontinue support for older models. Although these upgrades will be coordinated with the check standardization project, they are not included in the project budget because the upgrades would have been necessary even without the check modernization initiative. For several Reserve Banks, these upgrades will constitute a significant portion of their 2001 capital expenditures.

## Developments in Federal Reserve Priced Services

The Monetary Control Act of 1980 requires that the Federal Reserve set fees for providing "priced services" to depository institutions that, over the long run, recover all the direct and indirect costs of providing the services as well as the imputed costs, such as the income taxes that would have been paid and the pretax return on equity that would have been earned had the services been provided by a private firm. The imputed costs and imputed profit are collectively referred to as the private-sector adjustment factor (PSAF).<sup>1</sup> Over the past ten years, the

Federal Reserve Banks have recovered 100.8 percent of their priced services costs, including the PSAF (see table).

Overall, fees charged in 2000 for priced services increased approximately 5.0 percent from 1999.<sup>2</sup> Revenue from priced services was \$881.5 million, other income related to priced services was \$41.3 million, and costs related to priced services were \$814.5 million, resulting in net revenue of \$108.3 million and a recovery rate of 101.1 percent of costs, including the PSAF.<sup>3</sup>

the Board of Governors that are related to priced services; in the pro forma statements at the end of this chapter, Board expenses are included in operating expenses, and Board assets are part of long-term assets.

2. Based on a chained Fisher ideal price index not adjusted for quality changes.

3. Financial data reported throughout this chapter—revenue, other income, cost, net revenue, and income before taxes—can be linked to the pro forma statements at the end of this chapter. *Other income* is revenue from investment of clear-

1. In addition to income taxes and the return on equity, the PSAF is made up of three imputed costs: interest on debt, sales taxes, and assessments for deposit insurance from the Federal Deposit Insurance Corporation. Also allocated to priced services are assets and personnel costs of

## Priced Services Cost Recovery, 1991–2000

Millions of dollars except as noted

Year	Revenue from services <sup>1</sup>	Operating expenses and imputed costs <sup>2</sup>	Targeted return on equity	Total expenses	Cost recovery (percent) <sup>3</sup>
1991 .....	750.2	692.0	32.5	724.5	103.5
1992 .....	760.8	710.7	24.9	735.6	103.4
1993 .....	774.5	820.4	17.5	837.9	92.4
1994 .....	767.2	760.2	21.0	781.2	98.2
1995 .....	765.2	752.7	31.5	784.2	97.6
1996 .....	815.9	746.4	42.9	789.3	103.4
1997 .....	818.8	752.8	54.3	807.1	101.5
1998 .....	839.8	743.2	66.8	809.9	103.7
1999 .....	867.6	775.7	57.2	833.0	104.2
2000 .....	922.8	814.5	98.4	912.9	101.1
<b>1991–2000 .....</b>	<b>8,082.8</b>	<b>7,568.6</b>	<b>447.0</b>	<b>8,015.6</b>	<b>100.8</b>

NOTE. In this and the following tables, components may not sum to totals or yield percentages shown because of rounding.

1. Includes revenue from services of \$7,836.2 million and other income and expense (net) of \$246.6 million for the ten-year period.

2. Includes operating expenses of \$6,652.9 million, imputed costs of \$546.9 million, and imputed income

taxes of \$275.3 million for the ten-year period. Also, the effect of one-time accounting changes of \$74.1 million and \$19.4 million is included for 1993 and 1995 respectively.

3. Revenue from services divided by total expenses.

## Check Collection

Federal Reserve Bank operating expenses and imputed costs for commercial check services in 2000 totaled \$675.9 million, compared with \$649.8 million in 1999. Revenue from check operations totaled \$728.6 million, and other income amounted to \$34.7 million. Net income from check services was \$87.4 million in 2000, a \$29.9 million or 52.0 percent increase compared with 1999 income.

The Reserve Banks handled 17.0 billion checks in 2000, a decrease of 0.5 percent from 1999 (see table). The volume of fine-sort checks—checks that are presorted by the depositing banks

according to paying bank—declined 10.7 percent, compared with a 6.3 percent decrease in 1999. The volume of checks deposited that required processing by the Reserve Banks increased 1.1 percent.

The Reserve Banks continued to encourage the use of electronic check products that make the collection system more efficient. In 2000 the percentage of all checks presented electronically by the Reserve Banks to paying banks was 20.4 percent (approximately 3.5 billion checks), compared with 18.9 percent in 1999. The Reserve Banks captured images of 7.2 percent of the checks they collected, compared with 5.2 percent in 1999. The New York Reserve Bank's Utica office continued a pilot project to assess the operational implications of capturing check images on high-speed sorters, while the Minneapolis Bank's Helena Branch continued to evaluate the cost savings and operational implications of using check images to expedite check returns.

ing balances, net of earnings credits, an amount termed net income on clearing balances. *Total cost* is the sum of operating expenses, imputed costs (interest on debt, interest on float, sales taxes, and the Federal Deposit Insurance Corporation assessment), imputed income taxes, and the targeted return on equity. *Net revenue* is revenue plus other income minus total cost.



## Activity in Federal Reserve Priced Services, 2000, 1999, and 1998

Thousands of items

Service	2000	1999	1998	Percent change	
				1999 to 2000	1998 to 1999
Commercial checks .....	16,993,800	17,075,008	16,573,463	-.5	3.0
Funds transfers .....	111,175	105,408	100,609	5.5	4.8
Securities transfers .....	5,666	5,147	5,115	10.1	.6
Commercial ACH .....	3,812,191	3,343,615	2,965,739	14.0	12.7
Noncash collection .....	519	613	755	-15.3	-18.8
Cash transportation .....	19	18	18	5.6	1.0

NOTE. Activity in *commercial checks* is the total number of commercial checks collected, including processed and fine-sort items; in *funds transfers* and *securities transfers*, the number of transactions originated on line and off line; in *commercial ACH*, the total number of commercial

items processed; in *noncash collection*, the number of items on which fees are assessed; and in *cash transportation*, the number of registered mail shipments and FRB-arranged armored carrier stops.

## Fedwire Funds Transfer and Net Settlement

Reserve Bank operating expenses and imputed costs for Fedwire funds transfer and net settlement services totaled \$56.8 million in 2000. Revenue from these operations totaled \$61.9 million, and other income amounted to \$2.7 million, resulting in net income of \$7.7 million.

*Funds Transfer*

The Fedwire funds transfer system allows depository institutions to draw on their reserve or clearing balances at the Reserve Banks and transfer funds to other institutions in the United States. The number of Fedwire funds transfers originated by depository institutions increased 5.5 percent in 2000, to 111.2 million. In April 2000 the Reserve Banks reduced the transfer fees for all volume tiers (table).

Depository institutions that do not have an electronic connection to the Fedwire funds transfer system can originate transfers via "off-line" telephone instructions. Off-line Fedwire operations are consolidated at the Federal Reserve Banks of Boston and Kansas City. In

2000 the off-line funds transaction surcharge increased from \$13.00 to \$15.00 to reflect more accurately the costs of off-line processing.

*Net Settlement*

The Federal Reserve allows participants in private clearing arrangements to exchange and settle transactions on a net basis through reserve- or clearing-account balances. Users of net settlement services include check clearinghouse associations, automated clearinghouse networks, credit card processors, automated teller machine networks, and funds transfer and securities transfer networks. The Federal Reserve offers three types of settlement service: the settlement sheet service, the Fedwire-based settlement service, and the enhanced net settlement service.<sup>4</sup>

The Reserve Banks provide settlement services to approximately ninety local and national private-sector clearing and settlement arrangements. In

4. The settlement sheet service is being phased out, and all participating arrangements will be required to move to the enhanced service by year-end 2001.

# Fees Paid by Depository Institutions for Selected Federal Reserve Priced Services, 1999–2000

Dollars

Item	1999	2000
<b>FEDWIRE FUNDS TRANSFERS, BY VOLUME TIER<sup>1</sup></b>		
<b>Tier</b>		
(number of transfers per month) <sup>2</sup>		
1 (1 to 2,500) .....	.34	.33
2 (2,501 to 80,000) .....	.27	.24
3 (80,001 and more) .....	.21	.17
<b>NET SETTLEMENT, BY TYPE OF SERVICE</b>		
<i>Settlement sheet</i>		
Entries, each .....	.95	.95
Files, each .....	12.00	12.00
Minimum per month .....	60–175	60–175
<i>Fedwire-based</i>		
Entries, each .....	.95	.95
Files, each .....	12.00	12.00
Minimum per month .....	100–175	100–175
<i>Enhanced</i>		
Entries, each .....	.95	.95
Files, each .....	12.00	12.00
Minimum per month .....	60	60
<b>BOOK-ENTRY SECURITIES</b>		
Account maintenance		
Per issue .....	.45	.45
Per account .....	15.00	15.00
Transfers, each <sup>2</sup> .....	.85	.70
<b>NONCASH COLLECTION</b>		
Bonds, each .....	50.00	40.00
Deposit envelopes		
(per envelope of coupons) <sup>3</sup>		
1–5 .....	4.75	4.75
6–50 .....	3.00	2.50
Cash letters		
(flat fee, by number of envelopes of coupons) <sup>3</sup>		
1–5 .....	7.50	7.50
6–50 .....	15.00	15.00
Return items, each .....	15.00	15.00

NOTE. Rates for 2000 are as of April 3.

1. Rates apply only to their specified volume tiers.

2. Originated and received.

3. Deposits and cash letters may contain no more than 50 envelopes of coupons.

2000 the Reserve Banks processed more than 424,000 settlement entries for these arrangements, and fees were held steady (table). The off-line settlement surcharge, however, was increased from

\$13.00 to \$15.00 to reflect more accurately the costs of off-line processing.

## Fedwire Book-Entry Securities

The Fedwire book-entry securities transfer system allows depository institutions to transfer Treasury and agency securities electronically to other institutions in the United States. Reserve Bank operating expenses and imputed costs for the Fedwire book-entry securities service totaled \$15.9 million in 2000. Revenue from these operations totaled \$17.8 million, and other income amounted to \$0.8 million, resulting in net income of \$2.6 million. The Reserve Banks processed 5.7 million transfers of government agency securities on the Fedwire book-entry securities transfer system during the year, an increase of 10.1 percent from 1999.<sup>5</sup>

Although the monthly account-maintenance fees were held steady in 2000, the basic per-transfer fee for book-entry securities transfers originated and received by a depository institution was reduced in April (table). As it was for funds transfers, the surcharge for off-line securities transactions was increased. The Federal Reserve operates a service at the Federal Reserve Bank of Chicago to facilitate the purchase and sale of Treasury and government agency securities by depository institutions in

5. The revenues, expenses, and volumes reported here are for transfers of securities issued by federal government agencies, government-sponsored enterprises, and international institutions such as the World Bank. The Fedwire book-entry securities service also provides custody, transfer, and settlement services for U.S. Treasury securities. The Reserve Banks act as fiscal agents of the United States when they provide transfer and safekeeping of U.S. Treasury securities, and the Treasury Department assesses fees on depository institutions for some of these services. For more detail, see the section “Fiscal Agency Services” later in this chapter.

the secondary market. The transaction fee for this service was held steady in 2000.

### Automated Clearinghouse

Reserve Bank operating expenses and imputed costs for commercial automated clearinghouse (ACH) services totaled \$61.6 million in 2000. Revenue from ACH operations totaled \$68.8 million, and other income amounted to \$2.9 million, resulting in net income of \$10.2 million, a \$1.7 million or 14.3 percent decrease compared with 1999. The Reserve Banks processed 3.8 billion commercial ACH transactions, an increase of 14.0 percent from 1999.

In 2000 the Board approved a new approach to pricing ACH transactions that the Federal Reserve Banks exchange with intermediaries that are defined as operators under the operating rules of the National Automated Clearing House Association. As part of that approach, the Board authorized the Reserve Banks to initiate discussions with the private-sector ACH operators (PSOs) to negotiate the structure and level of fees that the Reserve Banks will charge for processing interoperator transactions as well as the fees that the Reserve Banks will pay the PSOs.

### Noncash Collection

The Federal Reserve provides a service for the collection and processing of municipal bearer bonds and coupons. These securities, issued by local governments and states, are referred to as "noncash" items. Customer service for the noncash program has been centralized at the Federal Reserve Bank of Atlanta's Jacksonville Branch, which maintains a database of more than 3,500 paying agents. In 2000 the Jacksonville

Branch processed 519,000 noncash collection transactions.

Reserve Bank operating expenses and imputed costs for noncash collection services totaled \$2.0 million in 2000. Revenue from noncash operations totaled \$2.3 million, and other income amounted to \$0.1 million, resulting in net income of \$0.4 million. Two non-cash collection fees were reduced in 2000, and the others remained the same.

### Special Cash Services

The Reserve Banks charge fees for special cash services and nonstandard access.<sup>6</sup> Special cash services represent a very small portion (less than 1 percent) of the cost of overall cash services provided by the Reserve Banks to depository institutions. The Helena Branch of the Minneapolis Reserve Bank provides wrapped coin and coin in nonstandard packages; the Chicago District provides currency in nonstandard packages; and the El Paso Branch of the Dallas Reserve Bank provides nonstandard packaging of same-day express cash orders. In addition, the Boston, Kansas City, and San Francisco Districts and the Helena and El Paso Branches provide cash transportation by registered mail.

Reserve Bank operating expenses and imputed costs for special cash services totaled \$2.1 million in 2000. Revenue from cash operations totaled \$2.1 million, and other income amounted to \$0.1 million, resulting in net income of \$0.1 million.

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6. Nonstandard access refers to provisions of the Uniform Cash Access Policy that authorize Reserve Banks to charge fees to financial institutions when the number of weekly orders for currency or deposits of currency exceeds a uniform standard. Because nonstandard access is not considered a priced service, the fees are treated as a recovery of expenses rather than as revenue.

## Float

Federal Reserve float increased in 2000 to a daily average of \$774.2 million, from a daily average of \$584.4 million in 1999. The Federal Reserve recovers the cost of float associated with priced services as part of the fees for those services.

## Developments in Currency and Coin

Depository institutions held larger-than-normal amounts of vault cash in preparation for the public's potential need for additional cash during the period around the year 2000 (Y2K) date change. Because the Y2K event went smoothly, banks were eager to return the extra vault cash to the Reserve Banks in January 2000. To accommodate this large flowback of currency, Reserve Banks extended dock hours to receive currency deposits and worked extra shifts to process deposits. In January 2000, Reserve Banks received 4.0 billion notes, 61 percent more than the 2.5 billion notes received in January 1999 and 12 percent of the entire year's receipts. These extraordinary cash flows surrounding Y2K required close coordination among cash operations staff and economists responsible for open market operations to ensure that the large volume of currency in circulation was appropriately collateralized.

In January 2000 the U.S. Mint issued a new Golden Dollar, promoting the coin as a convenient alternative to the \$1 note. The Mint distributed Golden Dollars directly to selected retailers and through the Federal Reserve to the banking industry. Initially, the banking industry's demand for Golden Dollars exceeded the Mint's production capacity and the Federal Reserve's inventories. By midyear, after the Mint had

increased production, the Reserve Banks had enhanced their management of inventory, and banks had reduced their orders for Golden Dollars, the Federal Reserve's supply of the new coins was more than adequate to meet demand. Early evidence suggests that the Golden Dollars are not widely circulated but are collected by the public as commemorative coins.

In May the Department of the Treasury introduced the new-design \$5 and \$10 notes, thereby concluding the redesign that began in 1996 with the introduction of the new-design \$100 note. The new-design \$5 and \$10 notes contain the same features as the other 1996 Series notes, except that the \$5 note does not include color-shifting ink. There are no plans to redesign the \$1 note.

## Developments in Fiscal Agency and Government Depository Services

The Federal Reserve Act provides that, when required by the Secretary of the Treasury, Reserve Banks will act as fiscal agents and depositories of the United States. In this capacity, Reserve Banks provide debt-related services, collect and disburse funds on behalf of the federal government, and provide similar services for several domestic and international government agencies.

For example, as fiscal agents and depositories of the United States, Reserve Banks collect federal taxes for the Treasury, maintain a cash account for the Treasury to meet its immediate cash needs, and invest excess Treasury balances with depository institutions. The Federal Reserve adjusts the total Treasury balances at depository institutions according to the Treasury's cash needs and depository institutions' willingness and ability to collateralize Trea-

Expenses of Federal Reserve Banks for Fiscal Agency and Depository Services,  
2000, 1999, and 1998

Thousands of dollars

Agency and service	2000	1999	1998
<b>DEPARTMENT OF THE TREASURY</b>			
<i>Bureau of the Public Debt</i>			
Savings bonds .....	70,786.7	70,285.8	71,401.8
Treasury Direct .....	41,259.3	40,446.2	35,859.1
Commercial book entry .....	13,924.6	15,744.2	17,880.4
Marketable Treasury issues .....	14,224.3	13,715.1	15,530.5
Definitive securities and Treasury coupons .....	1,069.3	4,886.7	3,734.2
Other services .....	132.5	100.4	83.7
Total .....	141,404.7	145,178.4	144,489.7
<i>Financial Management Service</i>			
Treasury tax and loan and Treasury general account .....	38,649.0	34,971.0	35,428.2
Government check processing .....	31,866.9	33,365.4	34,096.4
Automated clearinghouse .....	10,799.1	11,263.4	11,716.0
Government agency check deposits .....	2,218.8	2,422.7	2,731.0
Fedwire funds transfers .....	182.9	187.7	186.3
Other services .....	27,015.4	20,423.5	16,045.2
Total .....	110,732.2	102,633.7	100,203.1
<i>Other Treasury</i>			
Total .....	10,362.8	7,786.8	6,237.6
Total, Treasury .....	262,499.7	255,598.9	250,930.4
<b>OTHER FEDERAL AGENCIES</b>			
Department of Agriculture			
Food coupons .....	16,463.7	18,643.9	24,452.4
U.S. Postal Service			
Postal money orders .....	9,213.5	6,623.3	5,275.3
Miscellaneous agencies			
Other services .....	13,747.1	13,983.0	16,850.6
Total, other agencies .....	39,424.3	39,250.2	46,578.3
<b>Total reimbursable expenses .....</b>	<b>301,924.0</b>	<b>294,849.1</b>	<b>297,508.7</b>

sury investments. Since October 2000 the Federal Reserve has been conducting these activities under the new, centralized Treasury Investment Program (TIP).

In 2000 the Reserve Banks focused on the consolidation of several fiscal agency and depository operations to improve the efficiency and quality of service provided to the Treasury and its customers. In addition to the implementation of TIP (see the discussion below, under "Federal Tax Payments"), the Reserve Banks completed the consolidation of Treasury Direct customer service operations and improved telephone service. The Reserve Banks and the Treasury's Bureau of the Public Debt

reduced the number of Treasury auction review sites as well.

The total cost of providing fiscal agency and depository services to the Treasury amounted to \$262.5 million, compared with \$255.6 million in 1999 (table). The cost of providing services to other government agencies was \$39.4 million, compared with \$39.3 million in 1999. The Reserve Banks establish uniform and consistent practices for accounting for, reporting of, and billing for the full costs of providing fiscal agency and depository services to the U.S. government. In 2000 the Reserve Banks requested reimbursement by the Treasury and other government agencies of \$301.9 million in fiscal agency

and depository expenses, an increase of \$7.1 million from 1999.

### Fiscal Agency Services

As fiscal agents, Reserve Banks provide the Department of the Treasury with services related to the federal debt. For example, they issue, transfer, reissue, exchange, and redeem marketable Treasury securities and savings bonds; they also process secondary market transfers initiated by depository institutions. The approximately 10,000 depository institutions that handle Treasury deposits are required to pledge to the Treasury collateral sufficient to protect the uninsured portion of Treasury tax proceeds and the full value of Treasury investments held. The Reserve Banks monitor the collateral pledged by depository institutions to the federal government. If the value of collateral is insufficient, the Federal Reserve removes the unprotected Treasury funds from that institution and invests them elsewhere.

### *Marketable Treasury Securities*

Reserve Bank operating expenses for activities related to marketable Treasury securities in 2000 (Treasury Direct, commercial book entry, marketable issues, definitive securities, and Treasury coupons) totaled \$70.5 million, a 5.8 percent decrease from 1999. Banks processed nearly 220,000 commercial tenders for government securities in Treasury auctions, a 13.0 percent decline from 1999. The New York Reserve Bank handles commercial tenders that come from within its District for government securities in Treasury auctions, including those from all primary dealers. The Bureau of the Public Debt assumed the processing of all other commercial tenders.

The Reserve Banks operate two book-entry securities systems for Treasury securities: the Fedwire system, which provides custody and transfer, and Treasury Direct, which provides custody services only.<sup>7</sup> Almost all book-entry Treasury securities, 97.2 percent of the total par value outstanding at year-end 2000, were maintained on Fedwire; the remainder were maintained on Treasury Direct.

The Reserve Banks in 2000 processed 7.7 million Fedwire transfers of Treasury securities, a 5.0 percent decline from 1999. They also processed 27.6 million interest and principal payments for Treasury and government agency securities, an increase of 3.9 percent from 1999.

Treasury Direct, operated by the Philadelphia Reserve Bank, is a system of book-entry securities accounts for institutions and individuals planning to hold their Treasury securities to maturity. The Treasury Direct system holds more than 669,000 accounts. During 2000 the Reserve Banks processed nearly 190,000 tenders for Treasury Direct customers seeking to purchase Treasury securities at Treasury auctions and handled 0.7 million reinvestment requests. The number of tenders was 20.5 percent lower than in 1999, and the number of reinvestment requests was 11.0 percent higher. The Philadelphia Reserve Bank issued 6.0 million payments for discounts, interest, and redemption proceeds; the Treasury Direct facility was also used to originate 2.7 million payments for savings bonds and more than 36,000 interest

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7. The Fedwire book-entry securities mechanism is also used for safekeeping and transfer of securities issued by federal government agencies, government-sponsored enterprises, and international institutions. For more details, see the section "Fedwire Book-Entry Securities" earlier in this chapter.

payments for definitive (paper) Treasury issues.

The Reserve Banks completed the consolidation of Treasury Direct customer service activities on schedule. All individual applications to purchase, reinvest, and redeem matured Treasury securities are handled by one of three Reserve Banks: Boston, Minneapolis, or Dallas. As part of the consolidation, the Reserve Banks implemented a toll-free customer contact center for Treasury Direct customers. The center routes calls to a variety of electronic services available from the Treasury and connects the call to the next available agent at one of the three Reserve Banks, regardless of the caller's location.

As a service to Treasury Direct investors, the Chicago Reserve Bank, through the Sell Direct program, continued to sell investors' Treasury securities on the secondary market for a fee. In 2000 the Bank sold more than 16,000 securities worth \$655.8 million, compared with more than 16,000 securities worth \$581.2 million in 1999. The Bank collected almost \$557,000 in fees on behalf of the Treasury, an increase of 4.1 percent from the almost \$535,000 in fees collected in 1999.

### *Savings Bonds*

Reserve Bank operating expenses for savings bond activities totaled \$70.8 million in 2000, an increase of 0.7 percent from 1999. The Banks printed and mailed 36.6 million savings bonds on behalf of the Treasury's Bureau of the Public Debt, a 9.6 percent decline from 1999. The Reserve Banks processed 2.3 million original-issue transactions for the Series I (inflation indexed) savings bond and 27.9 million original-issue transactions for the Series EE savings bond. They also processed approximately 568,000 redemp-

tion, reissue, and exchange transactions, a 3.0 percent increase from 1999. The Reserve Banks responded to 1.6 million service calls from owners of savings bonds, approximately the same number as in 1999.

The Reserve Banks continued to enhance the automation aspects of savings bond processing. All savings bond processing sites have implemented electronic scanning of paper applications submitted by banks. Work also continued on plans to replace several mainframe computer programs with distributed (personal computer) programs.

Savings bond operations are conducted at five Reserve Bank offices: Buffalo (New York District), Pittsburgh (Cleveland District), Richmond, Minneapolis, and Kansas City. All five offices process transactions, but only the Pittsburgh and Kansas City offices print and mail savings bonds.

### *Depository Services*

The Reserve Banks maintain the Treasury's funds account, accept deposits of federal taxes and fees, pay checks drawn on the Treasury's account, and make electronic payments on behalf of the Treasury.

### *Federal Tax Payments*

Reserve Bank operating expenses related to federal tax payment activities in 2000 totaled \$38.6 million. The Banks processed approximately 3.8 million electronic and 16,000 paper advices of credit from depository institutions handling tax payments for businesses and individuals. Advices of credit are notices from depository institutions to the Federal Reserve and the Treasury that summarize taxes collected on a given day. From 1999 to 2000 the volume of tax payments submitted elec-

tronically decreased 20.0 percent, and the volume of paper advices of credit declined 64.0 percent. The Reserve Banks also received a small number of tax payments directly.

Depository institutions that receive tax payments remit the funds to the Reserve Banks electronically through the Treasury's Electronic Federal Tax Payment System (EFTPS). Businesses that know their tax liability in advance of the tax due date authorize their depository institutions to debit their accounts for the tax they owe. On the due date, the depository institution sends tax payment information to one of two commercial banks that serve as the Treasury's EFTPS financial agents. The financial agents assemble the tax-payment information received and forward it to the Federal Reserve, which debits the taxpayer's depository institution account and places the money in the Treasury's account. Because some business taxpayers cannot determine their tax liability until the day their taxes are due, the Minneapolis Reserve Bank operates another automated system that allows depository institutions to make same-day tax payments on behalf of taxpayers directly to the Federal Reserve; in 2000, the Minneapolis Bank's same-day electronic system processed approximately 247,000 tax payments, totaling \$262.8 billion, from 9.4 million taxpayers.

The Reserve Banks made significant improvements to the electronic tax payments process in 2000. They worked during the year to implement TIP, which replaced the Treasury tax and loan (TT&L) system in October. The Reserve Banks moved from twelve TT&L applications to one centralized TIP application and database, which offers several advantages. Unlike TT&L, which held all transactions and processed them at the end of each day, TIP operates in real

time to invest Treasury funds, monitor the value of collateral pledged, and withdraw invested balances that are not fully collateralized. TIP, which is operated by the St. Louis Reserve Bank, also improves upon the investment capabilities that had been available to the Treasury under the TT&L system. Along with TIP, the St. Louis Reserve Bank implemented a separate application, the paper tax processing system, that converts paper tax payments to electronic form and truncates the paper tax coupons.

In a related matter, the Board modified its policy statement on payments system risk by establishing posting times for TIP transactions.

#### *Payments Processed for the Treasury*

Reserve Bank operating expenses related to government payment operations in 2000 (check processing, ACH, agency check deposits, and Fedwire) amounted to \$45.1 million. The Treasury continued to encourage electronic payments: ACH transactions processed for the Treasury amounted to 853.3 million, an increase of 3.6 percent from 1999. Most government ACH transactions are payments for social security, pensions, and salaries; some are payments to vendors. All recurring Treasury Direct payments and many definitive securities interest payments are ACH transactions.

In support of the Treasury's effort to make payments electronically, the Federal Reserve Bank of Dallas continued to operate the Electronic Transfer Accounts program. This program helps individuals who do not have bank accounts find low-cost transaction accounts at federally insured depository institutions so that they can receive their federal benefit payments electronically. The Dallas Bank enrolls depository



institutions that want to provide these accounts and helps payment recipients and others locate these institutions.

The Treasury continues to reduce the number of payments it makes by paper check. The Reserve Banks processed 262.0 million paper government checks in 2000, a decrease of 9.0 percent from 1999. The Banks also issued nearly 524,000 paper fiscal agency checks, a decrease of 14.0 percent from 1999. Fiscal agency checks are used primarily to pay semiannual interest on registered, definitive Treasury notes and bonds and on Series H and HH savings bonds; some were used to pay the principal of matured securities and coupons and to make discount payments to first-time purchasers of government securities through Treasury Direct.

### Services Provided to Other Entities

The Reserve Banks provide fiscal agency and depository services to other domestic and international agencies when they are required to do so by the Secretary of the Treasury or when they are required or permitted to do so by federal statute. Depending on the authority under which the services are provided, the Reserve Banks may (1) maintain book-entry accounts of government agency securities and handle their transfer,<sup>8</sup> (2) provide custody for the stock of unissued definitive securities, (3) maintain and update balances of outstanding book-entry and definitive securities for issuers, (4) perform various other securities-servicing activities, (5) maintain funds

accounts for some government agencies, and (6) provide various payment services.

One such service is the provision of food coupon services for the U.S. Department of Agriculture. Reserve Bank operating expenses for food coupon services in 2000 totaled \$16.5 million, 11.7 percent lower than in 1999. The Banks redeemed 685.7 billion food coupons, a decrease of 40.8 percent from 1999. The Department of Agriculture's program to provide benefits electronically is expected to continue reducing the volume of paper food coupons redeemed by the Reserve Banks.

As fiscal agents of the United States, the Reserve Banks also process all postal money orders deposited by banks for collection. The Reserve Banks processed 230.1 million postal money orders in 2000, 1.9 percent more than in 1999. Much of this work is centralized at the St. Louis Reserve Bank. In mid-2000 the St. Louis Reserve Bank implemented an image-capture service for paid postal money orders (similar to the service provided for Treasury checks) to facilitate the U.S. Postal Service's accounting, reconciliation, and claims processes.

### Information Technology

In 2000 the Federal Reserve made significant progress on its strategic initiative to implement frame relay technology on Fednet, the telecommunications network that supports both external electronic connections between the Federal Reserve and depository institutions and internal communications among Reserve Banks. Once complete, the new network will provide improved speed, reliability, and performance for depository institutions' electronic connections during contingencies and the capacity

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8. The Federal Reserve tracks the transfer and account maintenance of agency securities as a priced service to depository institutions. The agencies are not charged for the Federal Reserve's expenses in providing these services to depository institutions.

and flexibility to support new electronic services using web-based technologies. The Federal Reserve completed equipment installation at the three automated operations centers supporting national network services and began installing both internal and external frame relay connections. Approximately 1,500 telecommunications connections will be converted to frame relay technology through 2002.

Improvements in the security of the new FedLine for Windows platform continued in 2000. The security enhancements authenticate FedLine for Windows operators, encrypt information, and facilitate the connection of the FedLine for Windows terminal with the administrative systems of depository institutions. In 2000 the vendors building the enhancements completed the software development and integrated the Fedline for Windows security components. A complete Fedline for Windows package for depository institutions was prepared and tested in anticipation of converting dial customers from the Federal Reserve's current DOS FedLine platform to the new FedLine for Windows platform in 2001. Conversion will continue through the end of 2002.

Reserve Banks continue to make significant progress in using the World Wide Web as a delivery channel for financial services. In 2000 the Federal Reserve successfully implemented a public-key infrastructure to enable secure access to certain services through web browsers; collectively, these services are known as FedLine for the Web. The Federal Reserve currently offers web-based applications for check imaging, cash ordering, and savings bonds, and plans to launch other new services on FedLine for the Web over the next several years.

The Reserve Banks charge fees for the electronic connections depository

institutions use to access priced services; the Banks allocate costs and revenue associated with electronic access to the various priced services. The monthly cost of a Fednet connection ranged from \$75 to \$2,000, depending on the type and speed of the connection.

### **Financial Examinations of Federal Reserve Banks**

Section 21 of the Federal Reserve Act requires the Board of Governors to order an examination of each Federal Reserve Bank at least once a year. The Board engages a public accounting firm to perform an annual audit of the combined financial statements of the Reserve Banks (see the chapter later in this volume, "Federal Reserve Bank Combined Financial Statements"). The public accounting firm also audits the annual financial statements of each of the twelve Banks. The Reserve Banks use the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in assessing their internal controls over financial reporting, including the safeguarding of assets. Within this framework, each Reserve Bank provides an assertion letter to its board of directors annually confirming adherence to the COSO standards, and a public accounting firm certifies management's assertion and issues an attestation report to the Bank's board of directors and to the Board of Governors.

In 2000 the Congress amended the Federal Reserve Act to codify the practice of engaging an external accounting firm. The new Federal Reserve Act section 11B states, "The Board shall order an annual independent audit of each Federal Reserve Bank and the Board."

In 2000 the attention of the Board's Division of Reserve Bank Operations and Payment Systems at the Reserve

Banks focused on assessing the adequacy of internal controls at each Bank, using a format consistent with the integrated COSO framework. The scope of these examinations included comprehensive reviews of each Bank's internal control system in terms of the five COSO control components: control environment, risk assessment, control activities, information and communication, and monitoring.

The firm engaged for the audits of the individual and combined financial statements of the Reserve Banks for 2000 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$1.4 million. PwC also audited the Federal Reserve System's pension plan and thrift savings plan, the fees for which totaled \$0.2 million. In addition, the Board and the Reserve Banks engaged PwC for management consulting services. Fees for these services, totaling \$1.5 million in 2000, are not considered incompatible with the services provided by PwC as an independent auditor.

Each year, to assess compliance with the policies established by the Federal

Reserve's Federal Open Market Committee (FOMC), the division examines the accounts and holdings of the System Open Market Account at the Federal Reserve Bank of New York and the foreign currency operations conducted by that Bank. In addition, a public accounting firm certifies the schedule of participated asset and liability accounts and the related schedule of participated income accounts at year-end. Division personnel follow up on the results of these audits. The FOMC receives the external audit reports and the report on the division's follow-up.

### Income and Expenses

The accompanying table summarizes the income, expenses, and distributions of net earnings of the Federal Reserve Banks for 1999 and 2000.

Income in 2000 was \$33,964 million, compared with \$29,347 million in 1999. Total expenses were \$2,595 million (\$1,586 million in operating expenses, \$385 million in earnings credits granted to depository institutions, and \$188 mil-

### Income, Expenses, and Distribution of Net Earnings of Federal Reserve Banks, 2000 and 1999

Millions of dollars

Item	2000	1999
Current income .....	33,964	29,347
Current expenses .....	1,972	1,852
Operating expenses <sup>1</sup> .....	1,586	1,532
Earnings credits granted .....	385	321
Current net income .....	31,992	27,495
Net additions to (deductions from, -) current net income .....	-1,492	-526
Cost of unreimbursed services to Treasury .....	8	8
Assessments by the Board of Governors .....	624	699
For expenditures of Board .....	188	214
For cost of currency .....	436	485
Net income before payments to Treasury .....	29,868	26,262
Dividends paid .....	410	374
Transferred to surplus .....	4,115	479
Payments to Treasury <sup>2</sup> .....	25,344	25,410

1. Includes a net periodic credit for pension costs of \$393 million in 2000 and \$367 million in 1999.

2. Interest on Federal Reserve notes.

lion in assessments for expenditures by the Board of Governors). The cost of new currency was \$436 million. Revenue from priced services was \$881.5 million. Unreimbursed expenses for services provided to the Treasury and other government entities amounted to \$8 million.<sup>9</sup>

The profit and loss account showed a net loss of \$1,492 million. The loss was due primarily to unrealized losses on assets denominated in foreign currencies revalued to reflect current market exchange rates. Statutory dividends paid to member banks totaled \$410 million, \$36 million more than in 1999; the rise reflects an increase in the capital and surplus of member banks and a consequent increase in the paid-in capital stock of the Reserve Banks.

Payments to the Treasury in the form of interest on Federal Reserve notes totaled \$25,344 million in 2000, down

from \$25,410 million in 1999; the payments equal net income after the deduction of dividends paid and of the amount necessary to bring the surplus of the Reserve Banks to the level of capital paid in.

In the "Statistical Tables" chapter of this volume, table 5 details the income and expenses of each Federal Reserve Bank for 2000, and table 6 shows a condensed statement for each Bank for the years 1914 through 2000. A detailed account of the assessments and expenditures of the Board of Governors appears in the chapter "Board of Governors Financial Statements."

## Holdings of Securities and Loans

The Reserve Banks' average daily holdings of securities and loans during 2000 amounted to \$528,139 million, an increase of \$32,533 million from 1999 (see table). Holdings of U.S. government securities increased \$32,390 million, and holdings of loans increased \$144 million.

### Securities and Loans of Federal Reserve Banks, 1998–2000

Millions of dollars except as noted

Item and year	Total	U.S. government securities <sup>1</sup>	Loans <sup>2</sup>
<i>Average daily holdings<sup>3</sup></i>			
1998 .....	447,095	446,933	161
1999 .....	495,606	495,384	221
2000 .....	528,139	527,774	365
<i>Earnings</i>			
1998 .....	26,851	26,842	9
1999 .....	28,227	28,216	11
2000 .....	32,760	32,737	23
<i>Average interest rate (percent)</i>			
1998 .....	6.01	6.01	5.44
1999 .....	5.70	5.70	5.02
2000 .....	6.20	6.20	6.27

1. Includes federal agency obligations.

2. Does not include indebtedness assumed by the Federal Deposit Insurance Corporation.

3. Based on holdings at opening of business.

The average rate of interest earned on the Reserve Banks' holdings of government securities rose to 6.20 percent, from 5.7 percent in 1999, and the average rate of interest earned on loans rose to 6.27 percent from 5.02 percent.

### **Volume of Operations**

Table 8 in the "Statistical Tables" chapter shows the volume of operations in the principal departments of the Federal Reserve Banks for the years 1997 through 2000.

### **Federal Reserve Bank Premises**

In 2000 the construction of the Atlanta Bank's new headquarters building continued and the construction of its new Birmingham Branch building was completed. Construction began on the San Francisco Bank's new Phoenix cash-processing center.

The Board approved the Chicago Bank's request to move its check-processing function from its headquarters building to leased space near

Chicago's Midway Airport. Leasehold improvements to prepare the space for the Bank's operations continued.

Leases were renewed for check-processing centers in Charleston, West Virginia, for the Richmond Bank, and Peoria, Illinois, for the Chicago Bank.

In the New York District, the multi-year program of improvements to the new leased offices in New York City continued. Work also continued on the multiyear renovation of the interior of the headquarters building and on the cleaning and repair of the building's exterior stonework; in addition, work began on improvements to the building's main chiller plant.

Development of a project program and analysis of site development options for the Dallas Bank's new Houston Branch building continued.

The Kansas City Bank analyzed expansion options for its headquarters facility, and the Chicago Bank analyzed long-term planning options for its Detroit Branch.

The Richmond Bank continued the installation of exterior security enhancements to its headquarters building. ■

## Pro Forma Financial Statements for Federal Reserve Priced Services

### Pro Forma Balance Sheet for Priced Services, December 31, 2000 and 1999

Millions of dollars

Item	2000	1999
<i>Short-term assets (Note 1)</i>		
Imputed reserve requirements on clearing balances .....	667.0	777.2
Investment in marketable securities ...	6,002.6	6,994.8
Receivables .....	74.9	78.2
Materials and supplies .....	3.2	4.2
Prepaid expenses .....	35.2	24.4
Items in process of collection .....	<u>4,094.6</u>	<u>3,747.8</u>
Total short-term assets .....	10,877.4	11,626.5
<i>Long-term assets (Note 2)</i>		
Premises .....	471.9	431.7
Furniture and equipment .....	171.2	146.5
Leases and leasehold improvements ..	65.3	59.5
Prepaid pension costs .....	<u>659.9</u>	<u>542.8</u>
Total long-term assets .....	<u>1,368.3</u>	<u>1,180.5</u>
<b>Total assets .....</b>	<b>12,245.7</b>	<b>12,807.0</b>
<i>Short-term liabilities</i>		
Clearing balances and balances arising from early credit of uncollected items .....	6,891.2	7,996.3
Deferred-availability items .....	3,872.9	3,523.5
Short-term debt .....	<u>113.2</u>	<u>106.7</u>
Total short-term liabilities .....	10,877.4	11,626.5
<i>Long-term liabilities</i>		
Obligations under capital leases .....	.0	.0
Long-term debt .....	443.0	237.2
Postretirement/postemployment benefits obligation .....	<u>243.9</u>	<u>231.2</u>
Total long-term liabilities .....	<u>686.9</u>	<u>468.5</u>
<b>Total liabilities .....</b>	<b>11,564.3</b>	<b>12,095.0</b>
Equity .....	<u>681.4</u>	<u>712.0</u>
<b>Total liabilities and equity (Note 3) ..</b>	<b>12,245.7</b>	<b>12,807.0</b>

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## Pro Forma Income Statement for Federal Reserve Priced Services, 2000 and 1999

Millions of dollars

Item	2000	1999
Revenue from services provided to depository institutions (Note 4) .....	881.5	835.9
Operating expenses (Note 5) .....	<u>711.1</u>	<u>692.7</u>
Income from operations .....	170.5	143.2
Imputed costs (Note 6)		
Interest on float .....	12.8	8.7
Interest on debt .....	31.5	18.5
Sales taxes .....	9.3	9.8
FDIC insurance .....	<u>.0</u>	<u>2.7</u>
Income from operations after imputed costs .....	116.8	103.5
Other income and expenses (Note 7)		
Investment income .....	411.8	337.3
Earnings credits .....	<u>-370.5</u>	<u>-305.5</u>
Income before income taxes .....	158.1	135.3
Imputed income taxes (Note 8) .....	<u>49.8</u>	<u>43.3</u>
<b>Net income</b> .....	<b>108.3</b>	<b>92.0</b>
MEMO: Targeted return on equity (Note 9) ...	98.4	57.2

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## Pro Forma Income Statement for Federal Reserve Priced Services, by Service, 2000

Millions of dollars

Item	Total	Com- mercial check collection	Funds transfer and net settlement	Book- entry securities	Com- mercial ACH	Noncash collection	Cash services
Revenue from services (Note 4) .....	881.5	728.6	61.9	17.8	68.8	2.3	2.1
Operating expenses (Note 5) .....	<u>711.1</u>	<u>590.0</u>	<u>49.6</u>	<u>14.0</u>	<u>53.6</u>	<u>1.7</u>	<u>2.1</u>
Income from operations .....	170.5	138.6	12.3	3.8	15.2	.6	.0
Imputed costs (Note 6) .....	<u>53.6</u>	<u>45.7</u>	<u>3.7</u>	<u>.7</u>	<u>3.3</u>	<u>.2</u>	<u>.0</u>
Income from operations after imputed costs .....	116.9	92.9	8.6	3.0	11.9	.4	.0
Other income and expenses, net (Note 7) .....	<u>41.3</u>	<u>34.7</u>	<u>2.7</u>	<u>.8</u>	<u>2.9</u>	<u>.1</u>	<u>.1</u>
Income before income taxes ..	158.1	127.6	11.3	3.8	14.8	.5	.1
Imputed income taxes (Note 8) .....	<u>49.8</u>	<u>40.2</u>	<u>3.5</u>	<u>1.2</u>	<u>4.7</u>	<u>.2</u>	<u>.0</u>
<b>Net income</b> .....	<b>108.3</b>	<b>87.4</b>	<b>7.7</b>	<b>2.6</b>	<b>10.2</b>	<b>.4</b>	<b>.1</b>
MEMO: Targeted return on equity (Note 9) .....	98.4	79.3	9.1	1.8	7.9	.2	.1

NOTE. Components may not sum to totals because of rounding.

The accompanying notes are an integral part of these pro forma priced services financial statements.

## FEDERAL RESERVE BANKS

## NOTES TO PRO FORMA FINANCIAL STATEMENTS FOR PRICED SERVICES

## (1) SHORT-TERM ASSETS

The imputed reserve requirement on clearing balances held at Reserve Banks by depository institutions reflects a treatment comparable to that of compensating balances held at correspondent banks by respondent institutions. The reserve requirement imposed on respondent balances must be held as vault cash or as non-earning balances maintained at a Reserve Bank; thus, a portion of priced services clearing balances held with the Federal Reserve is shown as required reserves on the asset side of the balance sheet. The remainder of clearing balances is assumed to be invested in three-month Treasury bills, shown as investment in marketable securities.

Receivables are (1) amounts due the Reserve Banks for priced services and (2) the share of suspense-account and difference-account balances related to priced services.

Materials and supplies are the inventory value of short-term assets.

Prepaid expenses include salary advances and travel advances for priced-service personnel.

Items in process of collection is gross Federal Reserve cash items in process of collection (CIPC) stated on a basis comparable to that of a commercial bank. It reflects adjustments for intra-System items that would otherwise be double-counted on a consolidated Federal Reserve balance sheet; adjustments for items associated with non-priced items, such as those collected for government agencies; and adjustments for items associated with providing fixed availability or credit before items are received and processed. Among the costs to be recovered under the Monetary Control Act is the cost of float, or net CIPC during the period (the difference between gross CIPC and deferred-availability items, which is the portion of gross CIPC that involves a financing cost), valued at the federal funds rate.

## (2) LONG-TERM ASSETS

Consists of long-term assets used solely in priced services, the priced-services portion of long-term assets shared with nonpriced services, and an estimate of the assets of the Board of Governors used in the development of priced services. Effective Jan. 1, 1987, the Reserve Banks implemented the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (SFAS 87). Accordingly, the Reserve Banks recognized credits to expenses of \$115.5 million in 2000 and \$105.5 million in 1999 and corresponding increases in this asset account.

## (3) LIABILITIES AND EQUITY

Under the matched-book capital structure for assets that are not "self-financing," short-term assets are financed with short-term debt. Long-term assets are financed with long-term debt and equity in a proportion equal to the ratio of long-term debt to equity for the fifty largest bank holding companies, which are used in the model for the private-sector adjustment factor (PSAF). The PSAF consists of the taxes that would have been paid and the return on capital that would have been provided had priced services been furnished by a private-sector firm. Other

short-term liabilities include clearing balances maintained at Reserve Banks and deposit balances arising from float. Other long-term liabilities consist of accrued postemployment and postretirement benefits costs and obligations on capital leases.

## (4) REVENUE

Revenue represents charges to depository institutions for priced services and is realized from each institution through one of two methods: direct charges to an institution's account or charges against its accumulated earnings credits.

## (5) OPERATING EXPENSES

Operating expenses consist of the direct, indirect, and other general administrative expenses of the Reserve Banks for priced services plus the expenses for staff members of the Board of Governors working directly on the development of priced services. The expenses for Board staff members were \$4.2 million in 2000 and \$3.4 million in 1999. The credit to expenses under SFAS 87 (see note 2) is reflected in operating expenses.

The income statement by service reflects revenue, operating expenses, and imputed costs. Certain corporate overhead costs not closely related to any particular priced service are allocated to priced services in total based on an expense-ratio method, but are allocated among priced services based on management decision. Corporate overhead was allocated among the priced services during 2000 and 1999 as follows (in millions):

	2000	1999
Check .....	40.3	38.7
ACH .....	3.7	3.6
Funds transfer .....	4.3	4.7
Book entry .....	1.1	1.0
Noncash collection .....	.1	.0
Special cash services .....	.1	.0
<b>Total .....</b>	<b>49.6</b>	<b>48.0</b>

Total operating expense on the income statement by service does not equal the sum of operating expenses for each service because of the effect of SFAS 87. Although the portion of the SFAS 87 credit related to the current year is allocated to individual services, the amortization of the initial effect of implementation is reflected only at the System level.

## (6) IMPUTED COSTS

Imputed costs consist of interest on float, interest on debt, sales taxes, and the FDIC assessment. Interest on float is derived from the value of float to be recovered, either explicitly or through per-item fees, during the period. Float costs include costs for checks, book-entry securities, noncash collection, ACH, and funds transfers.

Interest is imputed on the debt assumed necessary to finance priced-service assets. The sales taxes and FDIC assessment that the Federal Reserve would have paid had it been a private-sector firm are among the components of the PSAF (see note 3).



Float costs are based on the actual float incurred for each priced service. Other imputed costs are allocated among priced services according to the ratio of operating expenses less shipping expenses for each service to the total expenses for all services less the total shipping expenses for all services.

The following list shows the daily average recovery of actual float by the Reserve Banks for 2000 in millions of dollars:

Total float	774.2
Unrecovered float	100.5
Float subject to recovery	673.7
Sources of recovery of float	
Income on clearing balances	67.5
As-of adjustments	470.8
Direct charges	322.7
Per-item fees	(187.3)

Unrecovered float includes float generated by services to government agencies and by other central bank services. Float recovered through income on clearing balances is the result of the increase in investable clearing balances; the increase is produced by a deduction for float for cash items in process of collection, which reduces imputed reserve requirements. The income on clearing balances reduces the float to be recovered through other means. As-of adjustments and direct charges refer to float that is created by interterritory check transportation and the observance of non-standard holidays by some depository institutions. Such float may be recovered from the depository institutions through adjustments to institution reserve or clearing balances or by billing institutions directly. Float recovered through direct charges and per-item fees is valued at the federal funds rate; credit float recovered through per-item fees has been subtracted from the cost base subject to recovery in 2000.

#### (7) OTHER INCOME AND EXPENSES

Consists of investment income on clearing balances and the cost of earnings credits. Investment income on clearing balances represents the average coupon-equivalent yield on three-month Treasury bills applied to the *total* clearing balance maintained, adjusted for the effect of reserve requirements on clearing balances. Expenses for earnings credits granted to depository institutions on their clearing balances are derived by applying the average federal funds rate to the *required* portion of the clearing balances, adjusted for the net effect of reserve requirements on clearing balances.

Because clearing balances relate directly to the Federal Reserve's offering of priced services, the income and cost associated with these balances are allocated to each service based on each service's ratio of income to total income.

#### (8) INCOME TAXES

Imputed income taxes are calculated at the effective tax rate derived from the PSAF model (see note 3).

#### (9) RETURN ON EQUITY

The after-tax rate of return on equity that the Federal Reserve would have earned had it been a private business firm, as derived from the PSAF model (see note 3). This amount is adjusted to reflect the recovery of \$1.2 million of automation consolidation costs for 1999. The Reserve Banks had recovered these amounts, along with a finance charge, by the end of 1999.

## *The Board of Governors and the Government Performance and Results Act*

Under the Government Performance and Results Act of 1993, federal agencies are required, in consultation with the Congress and outside stakeholders, to prepare a strategic plan covering a multiyear period and to submit annual performance plans and performance reports. Though not required to do so, the Board of Governors is voluntarily complying with the act's requirements.

### **Strategic and Performance Plans**

The Board sent its strategic plan for the period 1997–2002 to the Congress in October 1997. The document states the Board's mission, articulates major goals for the period, outlines strategies for achieving those goals, and discusses the environment and other factors that could affect their achievement. It also addresses issues that cut across agency jurisdictional lines, identifies key quantitative measures of performance, and discusses performance evaluation. The strategic plan for the period 2002–05 is being prepared; the mission, goals, and other elements of the plan will remain essentially unchanged.

In September 1998 the Board sent to the Congress a performance plan for its 1998–99 budget.<sup>1</sup> Except for the monetary policy function, the plan set forth

specific targets for some of the performance measures identified in the strategic plan. It also described the operational processes and resources needed to meet those targets and discussed validation and verification of results.

The strategic and performance plans are available on the Board's public web site ([www.federalreserve.gov/boarddocs/rptcongress](http://www.federalreserve.gov/boarddocs/rptcongress)). The mission statement of the Federal Reserve Board and a summary of the goals and objectives set forth in the strategic and performance plans are given below.

### **Mission**

The mission of the Federal Reserve Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.

### **Goals and Objectives**

The Federal Reserve has three primary goals with interrelated and mutually reinforcing elements:

#### **Goal**

To conduct monetary policy toward the achievement of maximum sustainable long-term growth and stable prices

#### **Objectives**

- Stay abreast of recent developments and prospects in the U.S. economy and financial markets and in those

1. The act requires that a performance plan be submitted for each fiscal year beginning with fiscal 1999. The Board budget covers two calendar years. The budget for 2000–01 was approved in September 1999. The budget and the informal performance plan for the 2000–01 period focused on management and human resource issues.

abroad, so that monetary policy decisions will be well informed

- Enhance our knowledge of the structural and behavioral relationships in the macroeconomic and financial markets, and improve the quality of the data used to gauge economic performance, through developmental research activities
- Implement monetary policy effectively in rapidly changing economic circumstances and in an evolving financial market structure
- Contribute to the development of U.S. international policies and procedures, in cooperation with the Department of the Treasury and other agencies
- Promote understanding of Federal Reserve policy among other government policy officials and the general public.
- Promote sound practices for managing risk at banking organizations to provide for strong internal controls, active boards of directors, and senior management oversight and accountability
- Promote sound banking and effective supervisory practices among developed and emerging countries through ongoing coordination with international supervisory bodies and through training programs for international supervisors and bankers
- Heighten the positive effect of market discipline on banking organizations by encouraging improved disclosures, accounting standards, risk measurement, and overall market transparency
- Harness benefits of technology in carrying out responsibilities to improve supervisory efficiency and to reduce burden on banking organizations

## Goal

To promote a safe, sound, competitive, and accessible banking system and stable financial markets

## Objectives

- Provide comprehensive and effective supervision of U.S. banks, bank and financial holding companies, U.S. operations of foreign banking organizations, and related entities
- Promote overall financial stability, management, and containment of systemic risk and ensure that emerging financial crises are identified early and successfully resolved by focusing supervisory efforts and resources on areas of highest risk to individual organizations and the financial system as a whole, and by developing effective regulations to promote a safe and sound banking environment
- Maintain an understanding of the effect of financial innovation and technology (for example, new powers and products, new risk management and measurement methodologies, and electronic banking) on the operations and risk profile of banking organizations and the payment system; ensure that supervisory programs accommodate prudent advances that benefit consumers and businesses or improve risk management
- Remove unnecessary banking restrictions and refine or eliminate unnecessary or ineffective policies, procedures, regulations, or restrictions to ensure that reforms are effectively implemented, all in a manner consistent with the safety and soundness of banking organizations
- Assure fair access to financial services for all Americans through vigorous enforcement of the Equal Credit Opportunity, Fair Housing, Commu-

nity Reinvestment, and Home Mortgage Disclosure Acts and by encouraging state member bank involvement in community development activities

- Administer and ensure compliance with consumer protection statutes relating to consumer financial transactions (such as the Truth in Lending, Truth in Savings, Consumer Leasing, and Electronic Fund Transfer Acts) to carry out congressional intent, striking the proper balance between protection of consumers and regulatory burden to the industry
- Implement appropriate rules, regulations, and policies to comply with the Gramm–Leach–Bliley Act, which was enacted in November 1999.

## Goal

Provide high-quality professional support to the Board in overseeing Reserve Bank operations and in fostering the integrity, efficiency, and accessibility of U.S. payment and settlement systems.

## Objectives

- Develop sound, effective policies and regulations that foster payment system integrity, efficiency, and accessibility
- Produce high-quality assessments of Federal Reserve operations, projects, and initiatives that assist Federal Reserve management to foster and strengthen sound internal control systems and efficient and effective performance
- Conduct research and analysis that contribute to policy development and/or increase the Board's and others' understanding of payment system dynamics and risk.

## Interagency Coordination

Interagency coordination helps focus efforts to eliminate redundancy and lower costs. As required by the Government Performance and Results Act and in conformance with past practice, the Board has worked closely with other federal agencies to consider plans and strategies for programs, such as bank supervision, that cross jurisdictional lines. In particular, coordination with the Department of the Treasury and other agencies is evident throughout both the strategic and performance plans.

Much of the Board's formal effort to plan jointly has been made through the Federal Financial Institutions Examination Council (FFIEC), a group made up of the five federal agencies that regulate depository institutions.<sup>2</sup> In addition, a coordinating committee of representatives of the chief financial officers of the five agencies has been created to address and report on strategic planning issues of mutual concern. This working group has been meeting since June 1997. These and similar planning efforts can significantly lower the government's

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2. The FFIEC consists of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. It was established in 1979 pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978. The FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions. The FFIEC also provides uniform examiner training and has taken a lead in developing standardized software needed for major data collection programs to support the requirements of the Home Mortgage Disclosure Act and the Community Reinvestment Act.

costs for data processing and other institution costs for complying with federal regulations. ■  
activities as well as lower depository

## *Federal Legislative Developments*

The following federal laws enacted during 2000 affect the Federal Reserve System and the institutions it regulates: the American Homeownership and Economic Opportunity Act of 2000; the Commodity Futures Modernization Act of 2000; and the Electronic Signatures in Global and National Commerce Act.

### **American Homeownership and Economic Opportunity Act of 2000**

The American Homeownership and Economic Opportunity Act of 2000, Public Law 106-569, enacted on December 27, 2000, amends the Federal Reserve Act to reinstate and make permanent certain economic reports from the Board of Governors to the Congress. Under these amendments, the Chairman of the Board of Governors is required to appear semiannually before the Congress to report on the activities of the Federal Open Market Committee (FOMC), the Board's conduct of monetary policy, and the status of economic development. Furthermore, the act preserves the Board's obligation under section 10 of the Federal Reserve Act to annually provide the Congress with a written report on the activities and records of the FOMC. In addition, the act amends the Federal Reserve Act to permit the Board to acquire an additional site or building that will support the performance of the functions of the Board, and raises the Chairman's position of Board Chairman to Level I in the federal Executive Schedule and raises the position of Governor to Level II.

### **Commodity Futures Modernization Act of 2000**

The Commodity Futures Modernization Act of 2000, Public Law 106-102, enacted on December 21, 2000, amends the Commodity Exchange Act, as well as other federal banking and securities laws, to reform the regulatory framework for both over-the-counter (OTC) and exchange-traded derivatives. The act resolves issues about the enforceability of OTC derivatives transactions, including those that involve commercial banks, by excluding most of such transactions from the coverage of the Commodity Exchange Act.

In addition, two parts of the act specifically affect the Board's authority to regulate derivatives transactions. First, multilateral clearing organizations for derivatives transactions must be regulated either as federally regulated financial institutions, such as state member banks, or as clearing organizations registered with the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission. Second, the act amends the Commodity Exchange Act and the federal securities laws to permit trading of "security futures products." The act requires the Board to prescribe margin requirements for security futures products or to delegate this authority to the CFTC and the SEC jointly.

### **Electronic Signatures in Global and National Commerce Act**

The Electronic Signatures in Global and National Commerce Act, Public Law

106-229, was enacted on June 30, 2000. The act generally provides that a contract or other record relating to a transaction may be provided in electronic form and may not be denied legal effect or validity solely because it is in electronic form. For cases where information is required to be provided to consumers in writing, however, the act authorizes the use of electronic records only if the con-

sumer affirmatively consents to receive such records in electronic form and does not withdraw that consent. This legislation applies to consumer disclosures and transactional records, such as monthly account activity statements, that financial institutions provide. The act preserves certain other legal requirements such as those governing the content and timing of consumer disclosures. ■

## *Regulatory Simplification*

In 1978 the Board of Governors established a program of regulatory review to help minimize the burden of regulation on banking organizations. The objectives of the program are to ensure that all regulations, existing and proposed, represent the best course of action; to afford interested parties the opportunity to participate in the design of regulations and to comment on them; and to ensure that regulations are written in simple, clear language. Staff members regularly review Federal Reserve regulations for their adherence to these objectives and their consistency with the Regulatory Flexibility Act, which also requires that consideration be given to the economic consequences of regulation on small business. In its review process, the Board also follows the mandates of section 303 of the Riegle Community Development and Regulatory Improvement Act.

In 2000 the Board, as part of this review process, proposed revisions to Regulation C. It also issued an advance notice of rulemaking regarding capital for small banks.

### **Revisions Proposed to Regulation C**

In November the Federal Reserve requested comment on proposed revisions to Regulation C, which implements the Home Mortgage Disclosure Act (HMDA). The purposes of HMDA include helping determine whether financial institutions are serving the housing needs of their communities and assisting in fair lending enforcement.

The act requires depository institutions and certain for-profit nondeposi-

tory institutions to collect, report, and disclose data about applications for home mortgage and home improvement loans and about originations and purchases of such loans. Data reported include the type, purpose, and amount of the loan; the race or national origin, sex, and income of the loan applicant; and the location of the property.

The Board began the process of reviewing the regulation by issuing an advance notice of proposed rulemaking in 1998. The proposed revisions take into account comments received at that time as well as a wide range of discussions and special hearings held in 2000 on possible changes in the enforcement of the Home Ownership and Equity Protection Act (HOEPA).

In proposing changes to the HMDA reporting requirements, the Board aimed to improve the quality and utility of the resulting data. The Board also hoped the changes would enhance public understanding of the home mortgage market generally, and the subprime market in particular, and would improve fair lending analysis. At the same time, the Board attempted to minimize the increase in the data collection and reporting burden by limiting proposed changes to those likely to have significant benefit.

The proposed changes to Regulation C would

- Expand coverage of nondepository lenders by adding a dollar-volume threshold of \$50 million to the current loan-percentage test
- Simplify the definitions of “refinancing” and “home improvement loan” to generate more consistent and accurate data



- Require lenders to report home equity lines of credit (such reporting is now optional)
- Require lenders to report certain applications for credit received through preapproval programs
- Require lenders to report the annual percentage rate of the loan, whether the loan is subject to HOEPA, and whether the loan involves a manufactured home.

### **Simplified Capital Framework for Non-Complex Institutions**

In November the federal bank regulatory agencies requested public comment on an advance notice of proposed rule-making that considers the establishment of a simplified regulatory capital framework for non-complex banking organizations.

Banking organizations are required to maintain minimum levels of capital set by U.S. regulators under an international framework established by the 1988 Basel Capital Accord. Regulatory agencies in the United States and other

nations are revising the accord to provide a more refined assessment of the capital requirements for large, complex, internationally active banks.

As part of the revision process, agencies are considering simplified capital frameworks for non-complex banking organizations. The simplified framework would conform to the underlying principles of a revised Basel accord and maintain the principles of prudential supervision while relieving unnecessary regulatory burden, particularly that associated with regulatory capital calculations. The agencies have suggested criteria that could be used to determine eligibility for a simplified capital framework, such as the nature of a bank's activities, its asset size, and its risk profile. In the advance notice, the agencies sought comment on possible minimum regulatory capital requirements for non-complex institutions, including a simplified risk-based ratio, a simple leverage ratio, or a leverage ratio modified to incorporate certain off-balance-sheet exposures. ■